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COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

WRITTEN COMMENTS

ON

NEW REVENUE PROVISIONS IN THE PRESIDENT'S FISCAL YEAR 1997 BUDGET

JANUARY 8, 1997

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CONTENTS

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
April 15, 1996
No. FC-15

CONTACT: (202) 225-1721

Archer Announces Request for Written Comments on New Revenue Provisions in President's Fiscal Year 1997 Budget

Congressman Bill Archer (R-TX), Chairman of the Committee on Ways and Means, today announced that the Committee is requesting written public comments from all parties interested in certain revenue provisions in President Clinton's Fiscal Year 1997 budget.

BACKGROUND:

On March 19, 1996, President Clinton submitted his fiscal year 1997 budget to the Congress. The proposed budget contains several revenue provisions. While many of these revenue provisions were included in the Balanced Budget Act of 1995, a number were not. The Committee is requesting comment only on those provisions that were not included in the Balanced Budget Act of 1995.

DETAILS FOR SUBMISSIONS OF WRITTEN COMMENTS:

Persons submitting written comments should submit six (6) copies, with their address and date of request noted, by the close of business, Wednesday, May 15, 1996, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are now available over the Internet at GOPHER.HOUSE.GOV, under 'HOUSE COMMITTEE INFORMATION'.

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Comments

of
The Ad Hoc Coalition
on Intermarket Coordination

Submitted to

The Committee on Ways and Means
U.S. House of Representatives

May 15, 1996

These comments are submitted by the Ad Hoc Coalition on Intermarket Coordination, a coalition of the nation's leading options exchanges and their clearing firm, in response to Chairman Archer's request for comments on certain revenue provisions in the President's 1997 Budget. The participants in the Coalition are the American Stock Exchange, the Chicago Board Options Exchange, the Pacific Stock Exchange, the Philadelphia Stock Exchange, and The Options Clearing Corporation. The four exchanges account for approximately 99 percent of all transactions in exchange-traded options on individual equity securities.

OVERVIEW

The President's 1997 Budget includes two proposals of concern to the Coalition. One of these proposals is commonly referred to as the "short-against-the-box" proposal. The proposal is often described as being targeted against the short-against-the box transaction and, specifically, the ability of taxpayers under present law to defer recognition of gain until the transaction is completed. The legislative proposal included in the President's 1997 Budget, however, goes far beyond what is needed to stop such transactions and would fundamentally change long-standing tax principles by requiring recognition of gain (but not loss) on stocks, bonds and other financial instruments when taxpayers engage in various risk-reduction (i.e., hedging) strategies, including strategies involving the use of exchange-traded options. The vague language of the proposal also raises significant line-drawing questions, particularly with respect to options transactions.

If Congress decides to eliminate the tax benefits of the short-against-the-box transaction, a decision that the members of the Coalition believe should be made only after the relevant issues have been vetted in the normal legislative process, any legislation implementing that decision should be limited to that transaction. If other specific transactions are determined to be close substitutes for a short-against-the-box transaction, the legislation could also clearly identify those transactions and apply to them.

Exchange-traded options, which are created pursuant to established rules of the exchanges, have uniform and straight-forward terms intended to make them suitable for a broad range of risk-shifting and other investment-oriented transactions. Such options are used primarily to hedge short-term risks or to generate investment income and gains. To the best of the knowledge of the members of the Coalition, exchange-traded options are not used as substitutes for the short-against-the-box transaction. Moreover, hedges consisting of exchange-traded options are not economically equivalent to a short-against-the-box transaction. Accordingly, the Coalition opposes the Administration's Proposal to the extent it would apply to hedges consisting of exchange-traded options.

The second proposal addressed by these comments is the proposal to deny the dividends received deduction ("DRD") to a corporation that has hedged its risk of loss with respect to dividend-paying stock around the time of the dividend. The stated reason for this proposal is simply that the DRD should not be allowed when the owner of the stock does not bear the risk of loss inherent in the ownership of stock at the time a dividend is paid. The proposal does not appear to be aimed at any type of abusive transaction. Rather, it reflects a novel view of the function of the DRD that is at odds with the long-standing policy against imposing multiple layers of corporate-level taxes on the same income. The Coalition believes that current law adequately prevents "dividend stripping" and other tax-motivated transactions relating to the DRD and that it is inappropriate to impose multiple layers of corporate-level taxes on the same income simply because the owner of stock has hedged its risk around the time that a dividend is paid.

BACKGROUND

The options exchanges play an important role in the nation's economy. One of their most important functions is to permit individuals and firms that do not want to bear certain risks to transfer those risks to others who are more willing to bear them. In the words of the Securities and Exchange Commission, exchange-traded options:

> "provide a means for shifting the risk of unfavorable short-term stock price movements from owners of stock who have, but do not wish to bear these risks, to others who are willing to assume such risks in anticipation of possible rewards from favorable price movements."

SEC, Report of the Special Study of the Options Markets, House Committee on Interstate and Foreign Commerce (Committee Print 96-IFC3) 96th Cong. 1st Sess. 1 (1979).

The existence of options markets also tends to enhance the liquidity of the underlying markets. The options markets afford an efficient and cost-effective means of adjusting an investment's risk/return characteristics and provide market participants with the ability to create more diverse risk/return alternatives. These features tend to make participation in the underlying markets more attractive to a greater number of participants, thus increasing the liquidity in those markets.

The utility of the options markets is evidenced by the substantial volume of transactions on the options exchanges. In 1995, for example, 174.4 million options contracts on individual equities were traded on the options exchanges. The average daily volume for the year was 695,000 contracts, with each contract representing 100 shares of stock. The total option premiums for the year amounted to $50.8 billion.

DISCUSSION

I. The Short-Against-The-Box Proposal

The Administration's proposal would require gain recognition on an "appreciated financial position" held by a taxpayer whenever the taxpayer (i) enters into a transaction with respect to "substantially identical property" that "substantially eliminates the risk of loss and opportunity for gain" on such position "for some period" or (ii) enters into any other transaction that is marketed as being "economically equivalent" to such a transaction. These transactions are referred to as "constructive sales." Under the Administration's proposal, purchasing a put option or writing a call option on substantially identical property constitutes a constructive sale if the option is "substantially certain" to be exercised.[1]

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[1] See section 9512 of the President's 1997 Budget Bill.

The broad language of the Administration's proposal goes much further than changing the tax treatment of the short-against-the-box transaction. It would appear to reach many risk-reduction transactions that are not tax-motivated and are clearly not "abusive". This broad scope is plainly inconsistent with the fact that the Administration's proposal would trigger only gains and not losses.

The vagueness of the language used in the Administration's proposal raises significant line-drawing questions for hedging transactions that significantly reduce, but do not eliminate, risk of loss and opportunity for gain. The line-drawing questions are perhaps most significant for transactions involving the use of options, particularly exchange-traded options (also known as "listed" options). The uncertainty created by the proposed language will cause investors and traders to refrain from non-tax-motivated investment and hedging transactions because of the tax risk, leading to costly and undesirable market distortions and inefficiencies. Creating this type of uncertainty in the markets is clearly inappropriate in the absence of some Congressional finding that the options markets are being used by taxpayers to engage in transactions that are determined to be abusive.

The comments that follow discuss more specifically these and other concerns raised by the Administration's proposal and set forth recommendations for limiting the scope of the proposed legislation.

A. **<u>Options Transactions Are Fundamentally Different from the Short-Against-the-Box Transaction</u>** -- Options transactions are fundamentally different from the short-against-the-box transaction. <u>First</u>, exchange-traded options are generally used to hedge short-term risks or to generate investment income and gains. Since they are of limited duration, these options cannot be used to eliminate risk of loss and/or opportunity for gain for an indefinite period (or until death), as is the case with the short-against-the-box transaction. Thus, even though a taxpayer may reduce his risk during the term of the option, entering into the option transaction affords no protection from risks for the period beyond the term of the option.

Although a taxpayer could conceivably enter into a series of options transactions, one after the other as each option expires or is closed out, doing so would not be an efficient means of obtaining tax deferral. This is true for the following reasons:

- If the value of the hedged stock declines and the value of the option increases, the gain that was in the stock will essentially shift over to the option, and the gain on the option will be recognized at or before the time the option expires. Thus, the taxpayer cannot have any assurance of deferring gain recognition through a series of option transactions.

- Alternatively, if the value of the stock increases, and the value of the option declines, the taxpayer will have to invest a greater amount of capital to replace the option.

- Each time the taxpayer enters into a new options transaction, he would create a new straddle under Code section 1092. Gains on any such options would be taxed when the options are closed out or expire, while losses on such options would be deferred under the straddle rules.[2/]

[2/] Since the straddle rules defer losses to the extent of unrecognized gains in offsetting positions without regard to when the gains accrue economically, a loss on the option due to the decline in its time value will not be allowed even where the

(continued...)

Thus, over time the taxpayer would be "whipsawed" with respect to gains and losses on the options.[3] In addition, under Code section 263(g) the taxpayer would have to capitalize any interest and carrying charges allocable to the positions in the straddle.

- Each time the taxpayer enters into a new options transaction, he would incur additional transaction costs.

Second, unlike a short-against-the-box transaction, which completely eliminates upside and downside risk, exchange-traded options transactions can never completely eliminate such risk. For example, writing a deep-in-the-money call may reduce downside risk (as well as upside potential), but the taxpayer still bears the risk that the stock may drop below the strike price of the option. Even in the recent bull market, one can point to numerous examples of steep declines in the values of individual stocks over relatively short periods of time. Unlike a short-against-the-box transaction, a deep-in-the-money call does not protect an investor against such risks. Similarly, a taxpayer who purchases a deep-in-the-money put with respect to stock that he holds still has an opportunity for gain if the stock price rises above the strike price of the put.

In addition, a taxpayer who hedges a stock with exchange-traded options continues to receive any dividend on the stock and has no obligation to make any comparable payments to another party. Thus, the taxpayer continues to receive the economic return attributable to the dividend, and he bears the risk that the dividend may decrease (as well as the potential benefit from an increase in the dividend).[4]

Third, options transactions that may be covered by the proposal are entered into for non-tax reasons. The options transaction that comes closest to a short-against-the-box transaction is known as a "forward conversion," which consists of (i) long stock and (ii) a long put and a short call with the same strike price and the same expiration date. A forward conversion comes very close to eliminating downside risk and upside potential during the life of the options. Nonetheless, the principal use of forward conversions is in a non-tax-motivated arbitrage strategy that locks in small profits based on price discrepancies in the stock and options markets.[5] These arbitrage transactions would take place even if there were no tax system.

Similarly, a taxpayer who wants to hedge his stock (whether appreciated, depreciated or flat) may purchase a put to protect against perceived short-term risk. In order to finance the cost of the put, the taxpayer may write a call and use the premium

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[2](...continued)
value of the stock, which had appreciated before the options transaction was entered into, remains unchanged during the life of the option.

[3] The applicability of the straddle rules to options is apparently one of the reasons that they are not viewed as an efficient means of deferring gains. See Kleinbard and Nigenhuis, Short Sales and Short Sale Principles in Contemporary Applications, 53d N.Y.U. Institute of Taxation § 17.01(1) n.3. (1995) ("Options transactions seem to be less attractive to investors" as a tax deferral strategy than short-against-the-box and equity swap transactions in part because of the straddle rules).

[4] See J. Hull, Options, Futures and Other Derivative Securities, pp. 140-141 (2d ed. 1993).

[5] Because of transaction costs, these arbitrage profits can be captured only by large traders, stock specialists and market makers.

received for the call to pay for the put. For example, if a stock is trading at $42, a taxpayer might purchase a put at $40 for $2 and write a call at $45 for $2. The $2 premium received for the call would pay for the cost of the put. This transaction, which is known as a collar, is engaged in simply to hedge short-term risk at little or no cost and would be utilized even if there were no tax system. Nonetheless, it may be covered by the Administration's Proposal because the taxpayer may be viewed as retaining only limited downside risk and upside potential.

Fourth, exchange-traded options are particularly unsuited as substitutes for a short-against-the-box transaction. These options are standardized contracts, and the exchanges specify the strike price of an option and the date of expiration in accordance with their rules. An option is traded on an exchange only if the exchange authorizes trading in that option. Thus, listed options cannot be customized to suit an individual taxpayer's situation.

Under the rules that govern the listing of options, the exchanges do not create deep-in-the-money options. Rather, listed options are created at strike prices that are very close to the current price of the stock.[6] For example, if a stock is trading at $48, the exchanges would create options at strike prices of $45 and $50. Although options can become deep-in-the-money over time as a result of price movements in the stock, the extent to which a listed option can become deep-in-the-money is limited by the life of the option and the volatility of the stock. For example, for a stock trading at $48 in June, the exchanges would create new options with strike prices of $45 and $50 expiring in February of the following year. If the stock goes up to $100 by the following January, these $45 and $50 March options will still be listed for trading on the exchange. However, a stock whose value increased by such a great amount in such a short period of time is a very volatile stock, and thus its market value could change so rapidly that deep-in-the-money options may provide relatively little protection.

In addition, exchange-traded stock options are American-style options, which means they can be exercised at any time prior to expiration. Thus, for example, an investor who writes an in-the-money call option is at risk that the option will be exercised against him at any time. A taxpayer seeking deferral of gain would prefer the certainty of a European-style option, which can be exercised only at expiration.

Fifth, the vast majority (roughly 90%) of exchange-traded equity options are closed out or expire unexercised. Taxpayers who use options as hedges generally continue to hold their stock after they close out the option or the option expires. Entering into the hedge is not simply a prelude to disposing of the stock. These hedges are thus distinguishable from the types of options transactions apparently envisioned by the Administration's proposal, which consist of selling a call or buying a put that is substantially certain to be exercised. That language seems to reflect the view that such options should be treated as constructive sales because they are in effect a forward sale, i.e., the taxpayer has entered into a transaction that will result in the sale of an asset at a certain price but is able to defer the recognition of the gain for tax purposes. This analysis does not apply to hedges where the taxpayer continues to hold the asset after the option expires or is closed out.

Finally, unlike the short-against-the-box transaction, which is a well-defined transaction, the types of options transactions that are potentially subject to the Administration's Proposal are highly uncertain (i.e., the transactions are not well-defined). The Administration's Proposal would apply to certain options if they are "substantially certain" to be exercised or if the options "substantially eliminate" risk of

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[6] See, e.g., CBOE Rule 5.5, Interpretations and Policies .02. See generally Hull, supra, pp. 139-140.

loss and opportunity for gain "for some period." None of these terms has any precise meaning.

Applying such vague standards to options transactions will create unacceptable uncertainty in the markets.[7] Vague standards will cause taxpayers to refrain from engaging in non-tax-motivated transactions because of a fear that they may unknowingly trigger gain recognition in an appreciated stock position, which will lead to costly and undesirable market distortions and inefficiencies.

Recommendation: In light of these differences between options and the short-against-the-box transaction, the members of the Coalition believe that the legislation should not apply to hedges using listed options. Accordingly, hedges consisting of listed options should be excluded from the definition of a constructive sale.

B. Options as Appreciated Financial Positions. -- The Administration's proposal defines an appreciated financial position as including not only direct interests in stock, but also positions with respect to stock, including an option on the stock. If a taxpayer purchases a call option on a stock and the call increases in value, the call would be an appreciated financial position. If a taxpayer then enters into a transaction that substantially eliminates the risk of loss and opportunity for (additional) gain on the call, the gain on the call would be recognized.

As explained above, a listed option has a limited life that is set by the exchange pursuant to its rules. In order for an option to appreciate to any significant extent, some time must pass after it is initially entered into, and thus appreciated options positions will have an even shorter remaining life until expiration. Since any gain on the option will generally be recognized by the time the option is scheduled to expire, it seems unnecessary to treat such options as appreciated financial positions.

The taxpayer will recognize any gain on the option when he closes out the option or the option expires unexercised.[8] The taxpayer cannot avoid recognizing that gain by entering into a new options transaction. There is also no way that the term of an exchange-traded option can be extended.

It is also possible that the option will be exercised. Situations in which the option might be exercised fall into two categories, neither of which would be efficient from a tax-deferral perspective. First, if the appreciated option is a long put or a short call, the exercise of the option would force the taxpayer to sell stock and any gain on the option would generally be taxed as part of such sale. Second, if the taxpayer's option position consists of a long call or a short put, the taxpayer could either exercise the call or be assigned on the put, with the result that he would have to purchase the underlying stock. While in these situations any gain on the option would effectively be rolled into the stock, a taxpayer would not pursue this strategy to obtain deferral of gain in the option because (i) as compared with the relatively small cost of

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[7] The importance of certainty to the markets is illustrated by the existence of the "qualified covered call rules" in section 1092(c)(4), which provide mechanical tests for determining whether writing a covered call creates a straddle. Similarly, Congress clarified the rules for "securities lending transactions" in section 1058 so that taxpayers could have certainty as to whether a transaction would be treated as a sale. Congress provided this clarification because it recognized that securities lending transactions contribute to the liquidity of the securities market. See S. Rep. No. 95-762, 95th Cong. 2d Sess. 5 (1978), reprinted in 1978 U.S.C.C.A.N. 1286, 1290.

[8] As noted above, roughly 90% of exchange-traded options are closed out or expire unexercised.

the option, he would need to make a significant capital investment to acquire the stock, (ii) he would incur transaction costs on the purchase of the stock as well as on a subsequent sale of stock, and (iii) he would take on the risks of owning the stock.

Treating exchange-traded options as appreciated financial positions also creates some peculiar and undesirable results. For example, taxpayers holding stock frequently write calls, particularly qualified covered calls,[9/] with respect to stock that they hold. Writing covered calls is viewed by many as a conservative investment strategy that entails giving up the opportunity to benefit from an increase in the value of the stock during the life of the option in return for a more predictable return. If a taxpayer writes a qualified covered call and the underlying stock declines in value, the taxpayer will have a gain in the short call position.[10/] If the taxpayer then purchases additional shares of the stock, he may be entering into a constructive sale of the short call since, depending on the facts, the newly acquired long stock could be viewed as substantially eliminating the risk of loss and opportunity for gain on the short call. This inappropriate treatment could apparently apply even though the taxpayer's motivation was simply to acquire more of the stock (e.g., under a "dollar cost averaging" investment strategy).

In addition, treating listed options as within the scope of appreciated financial positions will create an additional realm of complexity in determining whether one or more options transactions "substantially eliminate" risk of loss and opportunity for gain on other options positions. The combinations of positions that are possible are much greater than when the appreciated financial position is a direct interest in stock, as is the case in the short-against-the-box transaction. In addition, there is a serious risk that the IRS would match up a taxpayer's positions in ways other than the taxpayer intended.

Recommendation: For all of the foregoing reasons, the options exchanges believe that listed options, as well as other short-term options, should be excluded from the definition of an appreciated financial position. Given the short-term nature of these instruments, excluding them from the scope of appreciated financial positions should not have any material effect on the revenue expected to be raised by the proposal

II. Holding Period Requirement for the DRD

Under current law, a corporation is not eligible for the DRD with respect to stock that is held for 45 days or less.[11/] For this purpose, any day that is more than 45 days after the date on which the stock goes ex-dividend is not taken into account. In addition, the corporation's holding period is reduced for periods in which the corporation has reduced its risk of owning the stock through entering into various transactions. See Code § 246(c). Once the corporation has satisfied this holding period requirement, the corporation is eligible for the DRD with respect to dividends on the stock without regard to whether the corporation has reduced its risk of loss with respect to the stock around the time of any particular dividend.

[9/] A qualified covered call is an exchange-traded call option that satisfies certain mechanical tests under section 1092. Qualified covered calls are not subject to the straddle rules.

[10/] Even if the stock price stays flat, the passage of time will give rise to gain in the short call position.

[11/] The holding period requirement is 91 days in the case of certain preferred stock.

The holding-period requirement of current law is designed to prevent "dividend-stripping" transactions in which a corporation would purchase stock shortly before the ex-dividend date and sell the stock shortly after that date. In the absence of the holding-period requirement, the corporation would receive dividend income eligible for the DRD and generate an off-setting short-term capital loss on the sale of the stock, which (all else being equal) would decline in value by roughly the amount of the dividend. This capital loss could be used to reduce unrelated capital gain. By requiring the corporations to hold the stock for more than 45 days, and by excluding for this purpose any days on which the taxpayer has reduced its risk, this rule requires a corporation to bear market risk associated with owning the stock for a sufficiently long period to make dividend stripping unattractive.

Current law also includes various other rules designed to prevent "tax arbitrage transactions" relating to the DRD. For example, no DRD is allowed with respect to a dividend if the corporation has an obligation to make related payments with respect to positions in substantially similar or related property. See Code § 246(c)(1)(B). Thus, a taxpayer that sells short against the box can not claim the DRD for any dividends it receives during the period of the short sale because it has an obligation to make "in lieu of dividend payments" to the stock lender. Another rule requires basis adjustments in stock when a corporation receives certain extraordinary dividends with respect to that stock unless the corporation has held the stock for a period of two years.[12] See Code § 1059. Yet another restriction is found in section 246A, which denies the DRD for debt-financed portfolio stock in order to prevent taxpayers from both claiming the DRD and deducting interest expense with respect to debt that finances the holding of the dividend-paying stock.

The Administration's proposal would take the current rules that are designed to prevent dividend-stripping and apply them with respect to each dividend. Thus, in order to be eligible for the DRD with respect to a dividend, the corporation would be required to hold the stock -- unhedged -- for at least 46 days around the time of the ex-dividend date. The stated reason for this proposal is simply that it is inappropriate for a taxpayer to receive the DRD if it is not at risk around the time of the dividend.

This policy change is difficult to justify. It would deny the DRD to a long-term holder of stock simply because it hedged its risks at a time proximate to a dividend payment. Other than as part of a package to reduce the benefits of the DRD, along with the Administration's proposal to reduce the DRD on portfolio stock from 70% to 50%, we see no rationale for the proposal. The effect of the proposal is to exacerbate the triple-tax problem that the DRD is intended to minimize. While the issue of whether to continue the longstanding policies that underlie the DRD is certainly a matter for Congress to decide, we do not believe that the fact that a corporation happens to hedge its risks over a dividend date is a reasonable basis for determining that the earnings distributed by the dividend should be subject to multiple layers of full corporate tax.

The fact that a taxpayer has reduced its risk of loss with respect to a stock does not mean that it is not the tax owner of the stock. Thus, in the absence of some abuse of the tax system or some inappropriate tax arbitrage, the fact that the taxpayer has reduced its risk is not a sufficient reason for denying it the benefits of ownership. This principle is evidenced by the treatment of holders of municipal bonds. The fact that a taxpayer that holds a municipal bond has hedged its risk with respect to the bond,

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[12] An amendment included in the Balanced Budget Act of 1995 and in the President's 1997 Budget would require immediate gain recognition with respect to stock in the case of certain extraordinary dividends.

say by purchasing a put on the bond, does not mean the interest that it receives on the bond is no longer tax-exempt. Similarly, there are a number of types of preferred stock, such as auction-rate preferred and mandatorily redeemable preferred, that include substantial risk-reduction features. Holders of such stock are entitled to the DRD under current law and would continue to be eligible for the DRD even under this proposal.

CONCLUSION

For the reasons set forth above, the members of the Coalition believe that any legislation designed to eliminate the tax benefits associated with the short-against-the-box transaction should not apply to hedges with exchange-traded options. Such options should also be excluded from the definition of an "appreciated financial position." Finally, the proposal to apply the current-law DRD holding period requirement to each dividend should not be adopted.

Airports Council International - North America
American Association of Port Authorities
American Planning Association
American Public Gas Association
American Public Power Association
Association of Local Housing Finance Agencies
American Metropolitan Sewerage Agencies
Council of Development Finance Agencies
Council of Infrastructure Financing Authorities
Education Finance Council
Equipment Leasing Association
Government Finance Officers Association
Municipal Treasurers' Association
National Association of Counties
National Association of Higher Educational Facilities Authorities
National Association of Housing & Redevelopment Officials
National Association of Independent Insurers
National Association of State Treasurers
National Association of State Universities and Land Grant Colleges
National Council of Health Facilities Finance Authorities
National Council of State Housing Agencies
National League of Cities
National Realty Committee
National School Boards Association
Public Securities Association
United States Conference of Mayors

May 15, 1996

Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Attn: Phillip Moseley, Chief of Staff

Dear Ways and Means Committee Members:

Re: Comments on Revenue Provisions Contained in President Clinton's Fiscal Year 1997 Budget Request: Extension of Pro Rata Disallowance of Tax-Exempt Interest Expense to All Corporations

The 25 organizations listed above are writing in opposition to the Administration's FY 1997 budget provision that adversely affects the demand for tax-exempt municipal bonds by extending to all corporations the deduction disallowance of interest expense for entities that hold tax-exempt interest securities. These organizations represent elected and appointed state and local government officials as well as underwriters, leasing companies, and financial services corporations that assist governments in their financings by purchasing their securities.

The Administration's proposal would have a significant negative effect on the financing costs of public entities at a time when the federal government is calling upon states and localities to undertake new responsibilities. The Administration's proposal is billed as a corporate welfare provision that purports to target corporate tax loopholes. However, if enacted, it would adversely affect corporate demand for tax-exempt debt and state and local government financing costs. This would lead to state and local government tax increases, or, more likely, a decrease in services to balance budgets.

Corporations would not be willing to purchase tax-exempt securities at the same interest rate if they lost the current law interest deduction. This valuable source of funding for state and local governments would be severely diminished. As a result, the cost of infrastructure facilities financed by municipal tax-exempt bonds and the cost of school buses, police cars, 911 phone systems, and other necessary governmental equipment acquired through a tax-exempt municipal leasing program would increase. With respect to municipal tax-exempt leases, if governments have to pay lessors the equivalent of a taxable interest rate, current rates that the governments pay could increase by as much as 50 to 60 percent.

Current Law

Under current law, the general rule is that no income tax deduction is allowed for interest on debt used directly or indirectly to acquire or hold tax-exempt securities. However, there are special rules that apply to various types of corporations. Nonfinancial corporations and certain other taxpayers are permitted to apply a tracing rule to determine if their interest expenses are permitted deductions. If a corporation can demonstrate that it did not finance its purchases of tax-exempt bonds through borrowing, no portion of its interest expense deduction is disallowed. Furthermore, the Internal Revenue Service (IRS) established in Revenue Procedure 72-18 two other "bright line" tests to assist taxpayers in complying with the law.

The first of these is the two percent *de minimis* rule. The rule provides that so long as the investor's holdings of municipal securities constitute less than two percent of it total assets, the IRS generally will not inquire whether any of the borrowings of the investor were incurred for the purpose of purchasing or carrying tax-exempt securities. The second test is a vendor financing exception, which allows a corporation to take nonnegotiable obligations in payment for goods or services rendered to a state or local government. A tax-exempt lease payment is an example of such a payment and a portion of that payment is tax-exempt income to the lessor.

The Clinton Administration's Proposal

Under the Clinton Administration proposal, all corporations would be treated the same as financial corporations are treated under current law. For example, all corporations would not be allowed an interest-expense deduction for the portion of their interest expense equal to the portion of their total assets that is comprised of tax-exempt securities. Additionally, this disallowance provision would apply to all related parties and would treat all members of a consolidated group as a single entity.

The Administration has proposed an exception to the affiliated companies section of its proposal for property and casualty firms, which in the aggregate hold approximately 13 percent of outstanding municipal bonds, but buy up to 50 percent of new issues. Because they generally do not borrow or incur substantial interest expenses, property and casualty firms are not affected by current-law restrictions on corporate municipal bond investors. Almost all of these firms, however, are part of a larger, consolidated corporate group that has debt outstanding and would have been caught by the new affiliated companies provision. The Administration's proposed exception for property and casualty firms is a step in the right direction and would restore demand for municipal bonds by this key group of bond buyers. However, it fails to address the concerns of other affected municipal bond purchasers.

The Administration proposed the extension of the pro rata disallowance provision to remove distinctions in the tax code that are related to the type of business activity a corporation conducts, and to apply similar tax rules to all corporations. The architects of the plan say that this approach recognizes that money is fungible and that borrowing for one purpose frees the taxpayer's remaining assets for other purposes. Although many of these rules have been in existence for almost 80 years, the administration claims that the current law permits the affected corporations to reduce their tax liabilities inappropriately through federal tax benefits of interest-expense deductions and tax-exempt interest income.

In previous attempts to amend the section of the tax code that sets forth these rules (Section 265), the charge has been made that corporations have deliberately engaged in arbitrage practices by borrowing in the short-term market and investing in tax-exempt obligations. Treasury officials also now claim that the new proposals are intended to "help" banks by equalizing the tax treatment of financing subsidiaries of large corporations with that of banks. Under current law, banks are permitted to take an interest deduction only for certain so-called "bank-qualified" bonds.

Impact on State and Local Governments

Corporate investors affected by the proposal, in its current form, hold about 6.8 percent of the approximately $1.3 trillion of outstanding municipal bonds. These corporations buy and hold a substantial amount of newly issued securities in the short-term market and in municipal leases. With the elimination of this corporate investor demand, the market would become more dependent on individuals and would become captive to individual investor sentiment and the flow of new monies into mutual funds. Interest rates would be more volatile and would be higher than now. The higher interest rates would be passed on to the government that is borrowing in the municipal market or entering into a municipal tax-exempt lease. Ironically, the proposed change would result in a greater revenue loss for the federal government because investors who are not affected by Section 265, that is, they are not borrowing funds and taking an interest deduction, would receive greater tax-exempt interest income, due to the loss in investor demand and the resulting higher rates.

Different types of corporations participate in the municipal market in different ways. Therefore, the administration's proposal could affect different types of municipal financing, as described below.

- *Short-term Borrowing*. Many corporations currently invest in short-term tax-exempt securities for cash management purposes. The 2 percent *de minimis* rule assures corporate investors that if they stay within the 2 percent limitation, they will not have to produce evidence of the relationship between their borrowing and their tax-exempt income. Corporate investment provides a great deal of liquidity in the market for short-term notes, and the administration's proposal would drastically curtail or eliminate corporate participation in this market.

  One example is the traveler's check and money order companies that invest their reserves in short- and medium-term tax-exempt securities. Most states have laws that strictly control traveler's check and money order businesses, requiring them to maintain substantial reserve funds and to invest those fund in very creditworthy securities such as Treasuries, municipals, or high-rated corporate securities. These companies are not using municipals as a tax dodge, but rather are buying tax-exempt bonds because state regulators view them as a safe investment. Thus, the Administration's proposal would curtail the level of demand these companies would have for municipals.

- *Tax-exempt Leasing*. States and localities routinely lease assets and equipment, such as school buses, police cars, phone systems, and computers. Equipment lessors estimate that their cost of financing for state and local governments would increase between 210 and 450 basis points because of the administration proposal. Although the administration's proposal would not apply to "certain nonsalable tax-exempt bonds acquired by a corporation in the ordinary course of business," this intended relief for state and local governments is illusory. The vast majority of equipment manufacturers who sell to state and local governments prefer not to hold municipal leases because they do not want to tie up their capital. These companies generally sell their financing contracts to third-party investors to generate the capital they need to continue to operate their businesses. Even where a manufacturer owns a captive finance company, the manufacturer would lose the vendor lease exemption when the lease was sold from the manufacturing company to the finance subsidiary.

An example of the impact on leasing costs has been provided by the Equipment Leasing Association. If a government enters a five-year lease for a $1 million 911 phone system and pays a 5.5 percent interest rate, the total amount repaid is $1,109,841. If the interest rate increases to a taxable equivalent of 9.0 percent, however, the total amount repaid increases 6.3 percent or by $69,482.

- *State and Local Housing Finance*. Federally sponsored corporations such as the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae) are active in the markets for state and local housing bonds. These corporations also would be affected by the tax law change, and there would be a powerful incentive for these corporations to withdraw their support from the state and local housing bond market even though these corporations are required under federal law to engage in activities relating to mortgages on housing for low- and moderate-income families.

Repeal of Deduction Disallowance Is At Odds With New State/Local Responsibilities

The attack on tax-exempt financing by the Clinton Administration, whether intended or not, is at odds with the President's historical position on tax-exempt financing. In the late 1980s, he served as a member of the Anthony Commission on Public Finance and expressed his support for tax-exempt bonds in a 1988 *New York Times* op-ed piece entitled, "America is Buckling and Leaking." He noted the impact of similar tax code changes when he wrote:

> "Tax revision has had a further destructive impact on local finance. The alternative minimum tax has reduced the number of purchasers of tax-exempt bonds while driving up the bonds' cost in capital-poor states like Arkansas. In effect, the government is shifting responsibility for meeting more public needs down to the state and local level while restricting the tools we need to respond."

At the very time Congress is calling upon state and local governments to undertake new responsibilities, the U.S. government should not increase the borrowing and leasing costs these entities will incur in carrying out those obligations. Many Members of the House Ways and Means Committee have already expressed opposition to the extension of the pro rata disallowance of tax-exempt interest expense to all corporations. We are grateful for this support for our position. State and local governments and the private-sector firms that support their ability to finance public projects and services are hopeful that this opposition will continue, and encourage Congress to reject this highly objectionable budget proposal.

For more information, please contact the Government Finance Officers Association at 202/429-2750 or the Public Securities Association at 202/434-8400.

American Association of Classified School Employees
American Federation of State, County and Municipal Employees
American Federation of Teachers
American Public Power Association
Fraternal Order of Police
Government Finance Officers Association
International Association of Firefighters
International Chiefs of Police
International City-County Management Association
International Personnel Management Association
National Association of Counties
National Association of Government Deferred Compensation Administrators
National Association of Police Organizations
National Association of State Auditors, Comptrollers and Treasurers
National Association of State Treasurers
National Conference of State Legislatures
National Education Association
National League of Cities
National Public Employee Labor Relations Board
National School Board Association
Service Employees International Union
United States Conference of Mayors

May 13, 1996

The Honorable Bill Archer, Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington D.C. 20515-6348

Dear Chairman Archer,

The above organizations respectfully request that this letter be submitted for the record in response to Chairman Archer's requests for comments on the FY '97 federal budget.

We urge you to pass, this year, as part of a budget reconciliation bill, a tax bill, or as a separate measure, a provision to protect $40 billion dollars of public employee retirement savings currently invested in Section 457 deferred compensation plans throughout the country. These plans are the primary vehicle used by government employees to set aside their own money for future retirement needs. The savings set aside under the rules of the plan are tax deferred until money is actually received at retirement.

Section 457 of the Internal Revenue Code requires deferred compensation plans to follow a number of rules. Most rules exist to ensure that money saved is in fact used for retirement. One rule, however, defeats both that goal and the broader national purpose of encouraging saving for retirement.

Section 457 (b)(6) requires the governmental employer to own assets of the deferred compensation plan--without recognition of the employee's interest in those assets. The IRC also requires that plan assets must be subject to the claims of the employer's creditors. During times of fiscal stress this requirement creates the possibility of seizure or manipulation of this money. Recent fiscal problems faced by local governments in Southern California and other jurisdictions emphasize that this is real.

Both Congress and the President have actively supported provisions requiring that all Section 457 assets be held in trust, or a similar mechanism, for the exclusive benefit of participants and their beneficiaries. This would repeal the current law requirement that amounts deferred under Section 457 deferred compensation plans are subject to the claims of the employer's creditors. This trust or similar insulating device would protect these funds to be used for retirement against raids and insolvency of the employer. No other change in the structure or operation of these plans is intended.

Congress, with the Committee on Ways and Means taking the lead, included such a requirement in the Balanced Budget Act of 1995. The President has included it in his FY '97 budget proposal and in his Retirement and Savings Plan, soon to be introduced in Congress. <u>Therefore, placing public employees' retirement assets at risk is entirely unnecessary</u>. <u>With agreement on this issue on all sides, it is urgent that such legislation be passed this year, as there was recently another public entity bankruptcy</u>.

Additionally, we urge you to support the other pension simplification provisions included in the 1995 Balanced Budget Act and in the President's proposals, as well. They include enhancements to Section 457 plans long supported by this coalition;

indexation of the $7500 maximum contribution; disbursement of small fund balances; and, a one-time change in the effective date of withdrawal of 457 deferred compensation funds, as well as changes to Section 415(a).

Since Congress enacted Section 457 in 1978 over $40 billion has been contributed by millions of public employees, including police, teachers, park rangers, firefighters, and construction crews. Nearly all plans exist without a penny of taxpayer support. Therefore, we urge you to work with Congress and the Administration to pass legislation this year that all sides can support to protect both these Section 457 assets and the fruits of self denial and savings by the men and women who serve all Americans. We thank you, in advance, for your consideration of this most important matter.

STATEMENT OF AMERICAN BANKERS ASSOCIATION
ON

Revenue Provisions contained in President Clinton's
Fiscal Year 1997 Budget Proposal
Committee on Ways and Means
U.S. House of Representatives

Increased Information Reporting Penalties

The ABA strongly opposes the Administration's proposal to increase penalties for failure to file information returns. Changes to the penalty structure solely for revenue raising purposes and without any underlying evidence to support a compliance problem is totally unwarranted and bad tax policy. The banking industry prepares and files a significant number of information returns annually in good faith for the sole benefit of the IRS. The current penalty structure provides more than enough incentive to file information returns properly, and the ABA strongly opposes the imposition of additional and unnecessary penalties for the sole purpose of raising revenue. This does not constitute "corporate welfare", or a "corporate loophole". The only way one could conclude that this proposal reduces "corporate welfare" or closes "corporate loopholes" would be to assume that corporations are noncompliant. There is no evidence suggesting noncompliance by corporations. The ABA, along with several other trade associations, objected to this measure when it was included in the Administration's December 7, 1995 budget proposal.

Limit Dividends Received Deduction

The ABA strongly opposes the Administration's most recent budget proposal to reduce the dividends-received deduction from 70% to 50% for corporations owning less than 20% of the stock of a U.S. corporation. The ABA, along with other trade associations and financial services companies, previously opposed this measure when it was included in the Administration's December 7, 1995 budget proposal. The Administration has not, however, provided any adequate justification for the reduction of this legitimate deduction. The dividends-received deduction currently prevents multiple level taxation of earnings from one corporation to another and does not constitute "corporate welfare", nor should it be considered a "corporate loophole". Such a limitation would create an unnecessary, unfair, and egregious multiple level corporate tax.

Modify Net Operating Loss Carry-back and Carry-forward Rules

The ABA opposes the Administration proposal to limit carry-backs of net operating losses (NOLs) to one year and extend carry-forwards to twenty years. Current law permits the use of NOLs to offset taxable income for three preceding taxable years and the succeeding fifteen taxable years to correct income distortions resulting from losses reported at the end of the taxable year. The proposed NOL carry-back limitation would further distort and prevent the reporting of accurate income for previous years. The Treasury Department explanation for the proposed limitation on NOL carry-backs cites increased complexity and administrative burden associated with carry-backs. Those reasons are inconsistent with sound tax policy and are not an adequate justification for a significant limitation on the NOL carry-back period. This proposal also may have non-revenue implications. Further studies are necessary in order to determine how such a proposal would impact regulatory capital. This provision should not be considered a "loophole" nor does it constitute "corporate welfare".

Require Reasonable Payment Assumptions for Interest Accruals on Certain Debt Instruments

The ABA opposes the provision in President Clinton's Fiscal Year 1997 budget requiring prepayment assumptions for interest accruals that would cause credit card issuers to pay tax on grace period interest before having a fixed right to the income. The proposal would require issuers to include currently in taxable income an estimate of the amount of grace period interest that will accrue in the future. This estimate would be based on the credit card issuer's assumptions of the likelihood that its credit card customers will not pay their entire balance before the end of the applicable grace period.

The Treasury Department claims that prepayment assumptions currently applicable to REMIC interests should be extended to credit card receivables in order to "equalize" the treatment of these two types of instruments. This goal is misplaced, however, because prepayment assumptions are used under present law only for the limited purpose of accruing discounts and premiums on REMIC interests, but are not used for accruing stated interest. Instead, stated interest on debt instruments (including credit card receivables) is accrued under the historic "all events test" whereby taxpayers pay federal income tax on taxable income determined by reducing fixed and determinable income by fixed and determinable expenses. A consistent application of the fixed and determinable standard to both income and expense preserves the integrity and fairness of the system even though some income or expense items may be taken into account at different times for financial statement purposes. Accrual method taxpayers are not entitled to deduct estimates of future expenses (such as bad debts) which, based on experience, are highly likely to be incurred. Predictions of uncertain future events have long been rejected as a basis for tax accounting on both the income and the expense side. In fact, since 1984 the accrual of expenses has been deferred beyond the time that they are fixed and determinable. A further one-sided departure from the historic "all events test" will significantly distort taxable income solely for the sake of a one-time revenue raiser.

This provision should not be considered a "loophole" nor does it constitute "corporate welfare." The ABA believes that this proposal can only be viewed as a tax increase and an arbitrary departure from well established tax policy.

Basis of Substantially Identical Securities Determined on an Average Basis

The ABA opposes the Administration proposal that would require taxpayers to determine their basis in substantially identical securities using the average of all of their holdings in the securities. The ABA also opposes the proposed requirement that taxpayers use the first-in, first-out (FIFO) method for purposes of determining whether gain or loss on the sale of a security is long-term or short-term.

The proposed elimination of the separate identification of stock or securities sold and the mandated use of the FIFO method for calculating the holding period unnecessarily creates additional and complex recordkeeping burdens. Taxpayers would be required to maintain two sets of records for each investment: one for average cost (which must be adjusted at the time of each purchase) and another for acquisition dates (which must be adjusted at the time of each purchase or sale). This additional burden is further complicated for taxpayers who maintain computerized records. The programming itself would be substantial in order to establish, maintain and adjust two sets of records at the time of each transaction. We oppose the significant imposition of costs and compliance burdens associated with this proposal to change the timing aspects of reporting gain or loss from the sale of stock or securities.

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May 15, 1996

Mr. Philip D. Mosely
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Mosely:

This letter contains a summary of the position of my client, the American Car Rental Association ("ACRA"), concerning the President's FY 1997 Budget Proposals. The President's proposal to extend permanently the luxury tax on automobiles is of great concern to ACRA. ACRA opposes extension of the tax.

ACRA is a national trade association representing most of the nation's major car rental companies, including Budget Rent A Car Corporation, Dollar Systems, Inc., Avis, Inc., National Car Rental System, Inc., Thrifty Rent A Car System, Inc., Enterprise Rent A Car, Inc., and Alamo Rent A Car, Inc. ACRA's members also include hundreds of small independent businesses which are franchisees/licensees or independent car rental companies.

ACRA opposes the permanent extension of the tax because the tax imposes an inequitable burden on the cost of rental car company inventories. The car rental industry purchases millions of new cars each year. The additional costs of the luxury tax on those cars to which the tax applies cannot always be passed on to the consumer and will result in car rental companies' purchasing fewer vehicles that are subject to the tax.

Moreover, the luxury tax on cars is not a tax on luxury for the car rental industry. Larger cars that are subject to the tax are frequently rented by small groups of business travelers or families on vacation, who need additional space provided by the larger vehicle. These types of consumers were not intended to be targeted by the luxury tax.

Finally, many car rental companies must pay this tax two or three times a year. Car rental companies cycle their fleets two or three times a year to assure their customers of low mileage vehicles. Such frequent payment of the luxury tax is a significant burden on cash flow, increasing the capital requirements for car rental companies even further.

The luxury tax on cars purchased by car rental companies has always been unfair. ACRA not only opposes the permanent extension of the tax, but urges Congress to pass legislation that would repeal the tax entirely.

ACRA appreciates the opportunity to comment on the President's 1997 Budget Proposals. ACRA looks forward to working with the Committee on Ways and Means on this and other tax measures during the coming months.

Sincerely,

J. Keith Ausbrook

J. KEITH AUSBROOK
Counsel to the
American Car Rental Association

JOINT STATEMENT OF THE AMERICAN COUNCIL FOR CAPITAL FORMATION, ET AL.

**WRITTEN TESTIMONY SUBMITTED TO THE
WAYS AND MEANS COMMITTEE
U.S. HOUSE OF REPRESENTATIVES**

**REGARDING A PROPOSAL INCLUDED IN PRESIDENT CLINTON'S
FISCAL 1997 BUDGET**

TO REDUCE THE DIVIDENDS-RECEIVED DEDUCTION

MAY 15, 1996

The undersigned trade associations and companies appreciate the opportunity to respond to the Chairman's request for testimony to the House Ways and Means Committee on the new tax provisions of President Clinton's fiscal 1997 budget plan. Specifically, we are testifying in opposition to the Administration's proposal to reduce the dividends-received deduction from 70 percent to 50 percent.

As the list of signers to this testimony demonstrates, a broad range of trade associations and companies are concerned that the proposal relating to the dividends-received deduction takes a detrimental approach towards the critical tax and economic policy issues involved in the proper treatment of intercorporate dividends.

This is particularly the case given Congress' interest in examining tax proposals, including proposals representing fundamental tax reform, that promote savings and investment and the competitiveness of U.S. business. The Coalition believes very strongly that the President's proposal is inconsistent with these goals, and is inconsistent with the long-standing objective of the dividends-received deduction itself, which clearly has been to reduce the incidence of the multiple taxation of corporate income.

CURRENT LAW AND THE PRESIDENT'S PROPOSAL

Under current law, a corporate holder of an instrument that has been issued by a U.S. corporation and classified as equity for tax purposes is entitled to a deduction for dividends received on that instrument. In general, the deduction is 70 percent of dividends received if the recipient owns less than 20 percent of the stock of the payor, or 80 percent if the recipient owns 20 percent or more of the stock. If recipient and payor are members of the same affiliated group, the deduction is 100 percent.

The Administration has proposed reducing the 70-percent deduction to 50 percent. The proposal would be effective for dividends paid or accrued more than 30 days after the date of enactment.

The Administration's terse rationale is that the current 70-percent deduction "is too generous for corporations that cannot be considered an alter ego of the distributing corporation because they do not have a sufficient ownership interest in that corporation."

HISTORY OF THE DIVIDENDS-RECEIVED DEDUCTION

The dividends-received deduction has existed in the federal tax law since 1909 -- when corporate income first became taxable. At the time, the dividends-received deduction was enacted to provide the full deductibility of intercorporate dividends. This 100 percent deduction ensured that income earned by a corporation was not taxed more than once at the corporate level.

The dividends-received deduction was reduced for the first time in 1935, to 90 percent, and then again in 1936 to 85 percent. During this period, the corporate income tax included a surtax applicable to income above a certain level, called the "surtax exemption amount." At the time, it was feared that a corporation would attempt to take advantage of multiple surtax exemptions by splitting its income among several subsidiaries, with subsidiary dividends being paid tax-free back to the parent, which received a 100-percent dividends-received deduction. The dividends-received deduction was reduced, therefore, to 85 percent in order to discourage "income splitting." The result, for the first time, was a second dose of corporate tax imposed on certain earnings (intercorporate dividends) before they had left the corporate sector.

The 100 percent dividends-received deduction was restored in 1964 for dividends paid within affiliated groups that elected to use only one surtax exemption. In 1975, the use of a single surtax exemption for an affiliated group became mandatory, so the rationale for reducing the dividends-received deduction was eliminated. Nevertheless, Congress at the time failed to restore the full dividends-received deduction for all corporations. As part of the Tax Reform Act of 1986, Congress reduced the dividends-received deduction from 85 percent to 80 percent, a move apparently intended to leave unchanged the effective tax rate on dividends as the corporate income tax rate was reduced.

Finally, in the Omnibus Budget Reconciliation Act of 1987, the deduction was reduced to 70 percent for dividends received from the stock of corporations in which the receiving corporation owns less than a 20 percent interest. The official rationale for reducing the deduction was that an 80-percent deduction was viewed as "too generous," although it was not explained how triple taxation could be "generous" in any degree. Of course, the paramount objective of the 1987 Act was to reduce forecasted budget deficits.

RATIONALE AND SUPPORT FOR CURRENT LAW

The history of the dividends-received deduction suggests that policy makers have consistently sought to use the deduction as a device to mitigate multiple layers of corporate tax. Without the dividends-received deduction, income would be taxed first when it is earned by a corporation, again when the remaining income is paid as a dividend to another corporate shareholder and, finally, a third time when the remaining income of the receiving corporation is paid as a dividend to an individual shareholder.

Without the deduction, the federal income tax on $100 of earnings could be nearly $75 after three levels of tax are applied.

The purpose of the dividends-received deduction is to mitigate the middle level of taxation, and a further reduction in the dividends-received deduction would exacerbate the triple taxation of intercorporate dividends. Reducing the dividends-reduced deduction runs counter to 85 years of corporate tax policy; moreover, taxing such income so heavily is both inequitable and distorts the economic decision-making process. These ill effects are present regardless of whether one corporation is an "alter ego" of another.

One such distortion would be to increase the cost of capital. Companies would tend to mitigate this result by raising capital through borrowing. Because interest is deductible, corporate earnings paid to investors in the form of interest, rather than dividends, would avoid the layers of tax imposed by the reduction or elimination of the dividends-received deduction. Yet policy makers have for some time questioned whether the tax law should encourage the use of debt over equity financing.

Moreover, there are sound, business reasons for one corporation to hold the stock in another, including regulatory requirements that apply to financial institutions and public utilities. It is thus inherently unfair and anti-competitive to penalize these and other companies that rely on equity rather than debt financing.

Moreover, a reduction in the dividends-received deduction would encourage corporations to raise equity capital by retaining earnings, rather than through new stock issuances. However, it can be argued that economic efficiencies are enhanced when earnings are distributed to shareholders.

Finally, while the corporation is an important form of business entity, the formation of which should be driven by business and economic concerns and not by tax considerations, the multiple taxation of corporate dividends can perversely encourage taxpayers to conduct business in non-corporate forms that are taxed only once on their earnings.

PERSONAL HOLDING COMPANIES

For personal holding companies, the incidence of three levels of tax on corporate dividends is very real. Personal holding companies face a 39.6-percent penalty tax if they do not pass on to their shareholders annually all dividends earned in a year on portfolio stock; personal holding companies really do not have an option to retain earnings and thus avoid multiple levels of tax. Therefore, all dividends earned by a personal holding company are subject to at least two federal income taxes -- a corporate income tax at the payor level and an individual shareholder tax when the amount is distributed by the personal holding company. A reduction in the dividends-received deduction to 50 percent increases the third level of tax -- from an effective tax rate of 12 percent to 20 percent at the personal holding company level and an overall tax on such earnings of nearly 69 percent.

MOVEMENT IN THE WRONG DIRECTION

There is good reason why well-meaning tax reform efforts have advocated reducing rather than increasing the multiple taxation of corporate income. In fact, tax policy and legal experts have advocated the "integration" of the income tax system for more than a generation.

It is ironic, therefore, that the proposal to reduce the dividends-received deduction comes at a time when Congressional leaders have committed themselves to tax reform proposals that correctly include only a single level of corporate income tax. While there are considerable differences over how a restructuring of the income tax system should be pursued, there appears to be a growing consensus in support of reducing the multiple taxation of corporate income.

Such proposals are founded in the fundamental goal that business investment, organization, and financial decisions be driven by economic and not tax considerations, and that, from a policy perspective, corporate net income should be taxed just like other income -- once and only once.

The Treasury Department, in 1984, recommended that triple taxation of corporate income be eliminated, and double taxation be halved, as part of its blueprint for an ideal tax system. Note that Treasury's recommendation was not limited to corporate "alter egos," since that concept is irrelevant to the fact, theory, or analysis of multiple taxation. A subsequent Treasury Department report, released in 1992,[1] documents the substantial economic benefits of integration and the economic distortions caused by the current multi-tiered system of taxing corporate income. The report concluded that any of three proposed integration prototypes would increase the capital stock in the corporate sector by $125 billion to $500 billion and would decrease the debt-to-asset ratio in the corporate sector from 1 to 7 percentage points.

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[1]Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems, January 1992.

Finally, most U.S. trading partners have adopted a single level of corporate taxation as a goal and provide some relief from double taxation of corporate income through corporate integration rules. To consider proposals that accentuate the problem of multiple taxation, rather than ameliorating this problem, will harm the international competitive position of U.S.-based corporations.

CONCLUSION

We urge the Committee not to consider the President's proposal to reduce the dividends-received deduction. Instead, changes to the deduction should be considered as part of the Committee's current comprehensive review of the income tax system. It is hoped that, as part of such a review, the Committee will agree that a more appropriate approach would be to reduce or eliminate the multiple taxation of corporation income, rather than further accentuate the inefficiencies and inequities of the current system.

This testimony is being submitted by the following trade associations and companies:

Trade Associations
The American Council for Capital Formation
American Insurance Association
Edison Electric Institute
Family Holding Company Group
Financial Executives Institute
Securities Industry Association
U.S. Chamber of Commerce

Companies
Baltimore Gas & Electric Company
Bear Stearns & Co., Inc.
The Chase Manhattan Corporation
Cinergy Corp.
Citicorp
Colonial Pipeline Company
Entergy
Household International
Houston Industries Incorporated
International Paper
J.P. Morgan & Co., Inc.
Kansas City Power & Light Company
Lehman Brothers Inc.
Merrill Lynch & Co., Inc.
Minnesota Power
Montana Power Company
Morgan Stanley & Co., Inc.
Nuveen Duff & Phelps Investment Advisors
Pitney Bowes Inc.
Prudential Securities

Statement for the Record

Mr. Sheldon Elliot Steinbach
Vice President and General Counsel
American Council on Education

HEARINGS BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
May 1, 1996

Mr. Chairman and Members of the Committee:

On behalf of the higher education associations listed below, we are pleased to file the following comments on the potential impact on America's charitable and educational organizations of replacing the federal income tax with an alternative tax system. This is an extremely serious issue about which the higher education community is deeply concerned.

I. Introduction

From the earliest colonial days, America's charities -- including its colleges and universities -- have helped define our national character and improve the quality of our individual lives. Such organizations are a uniquely American invention, one that grows out of our belief in the ability of private individuals to come together and work for the greater social good. No other country relies as heavily on the nonprofit sector to provide essential services such as education, health care, and disaster relief -- to name only a few of the myriad public purposes served by America's charitable institutions. And, in no other country is active participation and support by private individuals as important to the vitality of the nonprofit sector. Voluntary private giving accounts for 19% of the total support for our nonprofit sector. By contrast, in other developed countries where government provides virtually all public goods, there simply is no comparable tradition and practice of private giving. Not only is the nonprofit sector in these countries far smaller than in the U.S., it is also the case that private giving accounts for a dramatically smaller percentage of the nonprofit sector's total support.[1] At a time when government at all levels is reducing its support for public programs -- and, thus, shifting a greater share of the burden of offering these programs onto nonprofits -- it is critical that Congress maintain strong tax incentives for private giving.

The success of the American model in marshalling private generosity to foster public programs is nowhere more clearly evident than in our colleges and universities. Our system of higher education is the envy of the world. Every year hundreds of thousands of foreign students attend American educational institutions, both public and independent, to benefit from the highest quality instruction and research opportunities that are available here. America's colleges and universities are a key resource for ensuring long-term economic growth and international competitiveness. These institutions train the skilled and flexible workers business needs, nurture the scientific research that has made American industry a leader in new technology, and

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[1] In Germany and Italy, private giving accounts for just 4 percent of the support the nonprofit sector receives. In France and the U.K., private giving provides only 7 and 12 percent of total support respectively. Japan's nonprofit sector receives only 1 percent of its support from private contributions. Moreover, as noted above, it is important to bear in mind that in all of these countries, the nonprofit sector is far smaller than in the U.S. Chronicle of Philanthropy, at 1 (June 28, 1994) (reporting data from Johns Hopkins University Comparative Nonprofit Sector Project).

foster the spirit of innovation that is essential to a vital economy. Equally important, higher education broadens the base of individuals who benefit from the economic prosperity it helps create. Throughout the twentieth century, higher educational institutions have been the stepping stone for countless Americans to richer and more productive lives.

In recognition of the substantial public benefits colleges and universities provide, they have long enjoyed favorable tax status. The unique tax treatment of colleges and universities is deeply rooted in our common law tradition and has played a critical role in fostering the development of higher education. The three principal federal tax benefits bestowed on nonprofit educational organizations are (1) exemption from federal income tax, (2) eligibility to receive deductible contributions, and (3) access to tax-exempt financing.[2] Each of these benefits is vitally important to the financial health of our system of higher education.

Moreover, the importance of these supportive tax policies greatly transcends their direct financial value. This favorable tax treatment serves as a strong and visible affirmation by Congress that American colleges and universities, by virtue of the good they do and the high fiduciary standards they maintain, deserve broad public support.

II. Tax-exempt status for charitable and educational activities

Exemption from tax is the central element in the current system's treatment of charitable and educational organizations. The distinction between taxable and non-taxable organizations pervades the tax system and, more importantly, reinforces the fundamental distinction between enterprises organized for private gain and those created for public purposes. This distinction has been part of the Anglo-American system of taxation for centuries and is virtually axiomatic today. Moreover, the underlying policy rationale remains as compelling as ever: the public derives tremendous benefit from encouraging the commitment of private resources to nonprofit, nongovernmental efforts to advance the public good.

Tax-exempt status is widely understood to bring not only benefits but to impose burdens as well. The grant of tax exemption draws charitable organizations into a framework of legal rules and IRS oversight aimed at encouraging organizations to maintain a single-minded focus on their public service mission. Obviously, the public would lose the benefit of this accountability mechanism if charitable tax exemption were eliminated from federal tax law.

All of the various categories of tax reform proposals under consideration -- flat taxes, taxes on consumed income, and business transaction taxes (both the VAT and sales tax) -- can, <u>and should</u>, be designed to incorporate exemption for charitable and educational organizations.[3]

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[2] Technically, state supported colleges and universities receive these tax preferences by virtue of being governmental entities rather than because they are educational organizations in their own right. For the purpose of this statement, however, the distinction between public and independent institutions is not relevant.

[3] The mechanics of tax exemption are significantly more complicated in some systems than in others. For example, under a VAT, because tax is collected at each point of sale in the chain of production, exempt organizations would not only need to be exempted from the requirement that they collect VAT when they sell goods or services, but would also have to be given credits for the VAT they pay to suppliers when they make purchases.

III. The charitable deduction

The current income tax system incorporates important tax incentives for charitable giving. Individual taxpayers who itemize their deductions are permitted, within broad limits, to deduct charitable contributions. Similar income tax deductions are provided for corporations and estates. Gifts of appreciated property receive favorable treatment, with donors generally permitted to deduct the full value of the appreciated asset on their tax returns.

In contrast, several of the tax restructuring proposals currently on the table, at least in their pure forms, would eliminate these incentives for charitable giving. For example, the most widely discussed flat tax proposals would entirely eliminate the charitable deduction in the interest of broadening the tax base to achieve the lowest possible tax rate.[4] Similarly, a shift to either a national sales tax or a VAT would necessarily eliminate the deduction since under both systems, tax is imposed on individual transactions rather than on an individual's aggregate annual consumption expenditures.

It is important to stress at the outset that excluding charitable contributions from taxable income -- or from taxable consumption -- has a strong conceptual justification entirely independent of any stimulative effect on charitable giving. Resources that an individual voluntarily turns over to a charity to advance public purposes are not available to the donor to finance either present or future consumption. In this sense, charitable contributions are qualitatively different from any other consumption or investment use of personal assets. Because these assets are neither consumed nor saved for future private consumption -- but, instead, are invested for public purposes -- they are appropriately excluded from the tax base under either an income or consumption tax.

In considering the appropriate tax treatment of charitable contributions, it is also vital that Congress consider the importance of charitable giving to the ability of America's charities to meet their public service missions. For example, in 1994, voluntary contributions to higher education reached $12.35 billion.[5] This amount represents a substantial and essential element in the overall financing of higher education. While voluntary giving plays a somewhat larger role in financing independent colleges and universities, publicly supported institutions have long realized that they too must raise funds from private sources in order to provide quality instruction to their students and to support research. Indeed, many public colleges have established section 501(c)(3) foundations exclusively for fundraising purposes.

Of course, a host of factors other than the charitable deduction motivate individuals to give to colleges and universities. For some donors, the decision to give may grow out of a conscious recognition that an institution played a critical role in setting the course of his or her life; others give because they believe that support for education is an investment in the future; still others may give simply because they have fond memories of their college years. Whatever the reason for giving in individual cases, however, it is clear that,

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[4] Even if Congress enacted a flat tax that retained a deduction for charitable giving, the value the deduction for charities would be greatly reduced since its stimulus effect is a function of marginal tax rates which would significantly lower under a flat tax.

[5] Council for Aid to Education, Voluntary Support for Education 1994.

particularly for larger givers, the charitable deduction plays a key role in increasing the amount given.

The current deduction lowers the after tax price of giving for a top bracket taxpayer by roughly 40%. Taxpayers in lower brackets benefit from a smaller, though still substantial, reduction in the price of their charitable gifts. Accordingly, eliminating the deduction would substantially increase the real, after-tax cost of charitable giving for taxpayers who itemize their deductions.

Economists agree that such an increase in the price of giving would, if not offset by other factors, result in a decrease in giving. Historical experience suggests that the magnitude of this "price effect" is substantial. During the 1980s, when marginal tax rates dropped sharply, there was a correspondingly sharp drop in charitable giving. For example, IRS data show that between 1980 and 1991, average charitable giving for taxpayers with taxable income in excess of $1 million dropped from $207,000 to $100,000. More broadly, over the same period, total giving by itemizers declined substantially both as a percentage of their income and as a percentage of total giving.

Some proponents of structural tax reform suggest that the negative price effect of eliminating the charitable deduction would be largely, or even entirely, off-set by a countervailing "income effect." Empirical studies of charitable giving reveal that -- other things being equal -- donors increase the amount they give when they have more income. Noting this fact, some tax reform proponents argue that structural tax reform will trigger economic growth and increase incomes a point where the income effect will prevent the level of charitable giving from dropping despite losing the deduction. In this regard, we note that while it is certainly to be hoped that tax restructuring could both be revenue neutral and stimulate increased economic growth, achieving these goals is highly uncertain. As an organization representing nonprofit institutions that depend on private gifts to provide quality education, ACE recommends that Congress make appropriately conservative assumptions about increased economic growth when assessing the implications of tax restructuring proposals for charitable giving.

In a recent analysis of various proposals for tax restructuring, Professor Charles Clotfelter -- a noted expert on the impact of federal tax policy on charitable giving -- in collaboration with Professor Richard Schmalbeck, analyzed the possible impact of these countervailing price and income effects on charitable giving.[6] Reflecting the fact that neither the price nor the income effect can be estimated with precision, Clotfelter and Schmalbeck considered a range of possible price and income effects. The results are as follows:

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[6] Clotfelter and Schmalbeck, The Impact of Fundamental Tax Reform on Nonprofit Organizations, paper presented at the Brookings Institution conference, The Economic Effects of Fundamental Tax Reform (February 15-16, 1996) (April 6, 1996 version) (unpublished).

Category of gift	low price effect high income effect[7]	high price effect low income effect
Individual gifts	10% decline	22% decline
Corporate gifts	15% decline	45% decline
Bequests	24% decline	44% decline

Significantly, even using the most optimistic estimates of the price and income effects, the Clotfelter & Schmalbeck results indicate that individual giving will decline by 10 percent, corporate giving by 15 percent, and bequests by 25 percent. Using less optimistic estimates, the model projects declines of approximately twice these amounts.

Serious as these results would be for the charitable sector as a whole, they understate the adverse impact eliminating the charitable deduction would have on higher education. A disproportionately large share of gifts to colleges and universities are made by taxpayers in higher brackets who receive the largest incentives to give under the current system. Accordingly, colleges and universities would be disproportionately hard hit by eliminating the deduction.

Congress also needs to understand the direct impact that a reduction in giving to higher education would have on students struggling to pay for their educations. America's colleges and universities share a commitment to subsidizing the costs of education for those who cannot afford to pay regular tuition. In large part because of that commitment, higher educational institutions, both public and independent, are able to serve students of widely varying economic means. Colleges and universities are under considerable financial stress, however, as costs continue to rise and direct support from government continues to decline. In this context, it is obvious that any drop in private giving would translate into fewer funds for scholarship aid and reduced access to higher education for America's young people.

A major impetus for the tax restructuring proposals this Committee is considering is a recognition that America needs to encourage increased savings and investment. At the same time, many in Congress are calling for increasing private initiatives to address important public needs. Given these two goals, it would be ironic indeed if tax restructuring were to eliminate or erode current tax incentives for charitable giving -- the one aspect of current tax law that most directly addresses both of these critical objectives. Thus, in considering these proposals, Congress must carefully consider the impact each would have on charitable giving. Should Congress decide to adopt a tax system that eliminates or significantly reduces the effectiveness of the charitable deduction, then it is critical that the new system incorporate comparable incentives for charitable giving.

IV. <u>Tax-exempt financing</u>

The third important tax benefit granted to colleges and universities under the current tax rules is access to tax-exempt financing. By allowing purchasers of bonds issued on behalf of nonprofit educational organizations to exclude the interest they receive from their taxable income, the current tax system enables

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[7] In place of the "income effect," simulations of anticipated changes in bequests used contrasting assumptions about the effect changes in the size of the net disposable estate -- i.e. gross estate minus estate and gift tax credits -- would have on willingness to give at death.

colleges and universities to borrow at rates between 1.5 and 2.0 percentage points lower than taxable rate. This rate differential has a significant impact on colleges and universities' borrowing costs. For example a university that issued a thirty year tax-exempt bond for $10 million would pay $4.9 million more in interest than if the bond were taxable.

Tax-exempt bonds are a crucial means of financing major capital expenditures for a wide range of large nonprofit organizations -- all of which are barred by state and federal law from raising funds by issuing stock. Such financing is particularly important for higher education because of the large and costly physical plant required for both education and research activities. A recent study estimates the capital construction needs of American colleges and universities for new construction and essential maintenance of existing facilities at $60 billion. Because of a lack of capital funding, many institutions face a major deferred maintenance problem.[8] Moreover, this already serious situation is exacerbated by continuing reductions in direct support for higher education from the federal government.

We strongly urge Congress to consider the impact tax restructuring would have on the ability of higher education to finance critical capital improvements. Most flat tax proposals explicitly exempt interest income from tax, and thus would eliminate the preferred status of college and university bonds, forcing them to pay the same interest rate as regular corporate bonds.[9] A VAT or a sales tax would also erase the distinction between taxable and tax-exempt bonds.

If Congress chooses to enact either a flat tax or a business transaction tax, serious thought needs to be given to how higher education -- as well as other charities and state and local governments -- will be given access to affordable credit. As noted above, colleges and universities currently face continuing increases in the cost of providing education together with substantial reductions in government support. Hence, any increase in borrowing costs occasioned by the loss of tax-exempt financing will result in reduced scholarship aid, higher tuition, or diminished services.

Before leaving the subject of tax-exempt bonds, it is also important to note that if Congress ultimately decides to retain the existing income tax system, it should consider important improvements in the existing tax-exempt bond rules. In particular, ACE recommends that Congress remove the arbitrary distinction between governmental bonds and bonds issued on behalf of charitable and educational organizations. This distinction was introduced into the tax code as part of the Tax Reform Act of 1986 and has greatly -- and unnecessarily -- restricted access to tax-exempt financing by colleges and universities.

Most important, we urge Congress to repeal the $150 million dollar limit on bonds that may be issued on behalf of a

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[8] For scientific research facilities, the National Science Foundation has reported that for every $1 spent to maintain research facilities an additional $3.50 was deferred, and for every $1 spent for new science facilities $4.25 was deferred.

[9] Some proponents of tax restructuring argue that shifting to a consumption based tax will increase savings and cause interest rates to drop, so that charities and local governments will not see a rise in their borrowing costs. However, we believe the impact of tax restructuring on general interest rates is far too uncertain to support the conclusion that elimination of tax exemption financing will not have a major adverse impact on colleges and universities' ability to finance essential physical plans.

particular section 501(c)(3) organization. This limit was added to the tax code largely as means of limiting arbitrage by organizations that issued tax-exempt bonds and then invested the proceeds in taxable instruments paying a higher rate. Other tax-exempt bond rules subsequently added to the Code -- including arbitrage rebate requirements, bond maturity limits, hedge bond rules and advance refunding restrictions -- effectively address the arbitrage problem much more directly and efficiently. Hence, the $150 million dollar cap is no longer needed to control arbitrage.

The cap is causing higher educational institutions to incur increased financing costs and has greatly complicated the tax-exempt bond system for all organizations. There are already many colleges and universities that have reached the cap and are now forced to issue more costly taxable bonds to pay for badly needed capital improvements. Further, as Treasury stated in earlier testimony to this Committee, "the technical rules associated with the $150 million cap have proven complex and difficult to administer. Repeal of the cap would simplify the tax-exempt bond rules applicable to tax-exempt universities, charities, hospitals and other 501(c)(3) organizations."[10]

Given that the goal the cap was enacted to serve -- eliminating arbitrage -- has been fulfilled by other, more direct, tax law provisions, the hardship and complexity it has created serve no purpose. Hence, this arbitrary constraint on affordable borrowing by charitable and educational organizations should be repealed.

V. <u>Other issues raised by tax restructuring</u>

The developing debate on the impact of tax restructuring on charitable and educational organizations has focused primarily on how aspects of the current system that directly benefit such organizations could be retained or replicated. However, reform proposals should also be carefully reviewed to determine if they would inappropriately impose new burdens on charitable and educational organizations.

For example, ACE is concerned about the treatment of non-cash compensation paid by tax-exempt organizations under a consumption based flat tax of the sort proposed in H.R. 2060. Such a system would impose a flat tax on individuals and businesses but allow taxable employers to deduct cash compensation paid to employees. In contrast to the current system, employers would not, however, be allowed a deduction for non-cash compensation -- such as employer-provided health care benefits. In an apparent attempt to maintain parallel treatment between non-cash compensation paid by taxable and tax-exempt employers, H.R. 2060 would impose a special tax on tax-exempt organizations equal to the value of any such benefits paid by tax-exempt organizations times the corporate tax rate.

This aspect of H.R. 2060 would significantly increase the tax burden on tax-exempt organizations and would be particularly burdensome for labor-intensive charitable activities like higher education. Requiring charitable organizations to pay such a tax would also be inconsistent with the basic principle -- which is generally reflected in H.R. 2060 -- that income earned by charities should be exempt from taxation.

While not nearly as central as the core issues of exemption, deductibility of contributions, and tax-exempt financing, such

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[10] Statement of Leslie B. Samuels, Assistant Secretary (Tax Policy), Department of the Treasury, before the Subcommittee on Select Revenue Measures or the House Committee on Ways and Means, June 22, 1993.

second-order issues also can have a serious adverse impact on higher education. ACE will bring such issues to the Committee's attention as they emerge, and strongly urges the Committee to give them careful consideration.

V. Conclusion

America's colleges and universities face major new challenges as they confront substantial reductions in direct federal support. While the level of funding these institutions receive from governmental sources continues to decline, the need for books, classroom facilities, laboratories, and scholarships only increases. In light of the fundamental role higher education plays in our society and in our individual lives, this is precisely the wrong time to reduce the traditional tax support afforded to colleges and universities. As Congress evaluates replacing the existing income tax, it must consider that the flat tax, the VAT, and a national sales tax would eliminate tax incentives for charitable giving and tax exempt financing. Enacting any of these proposals without incorporating some specific measures to replace these tax supports would certainly have a grave impact on higher education.

The following associations join in this statement

American Council on Education
American Association of Community Colleges
American Association of State Colleges and Universities
Association of American Universities
Association of Community College Trustees
Association of Governing Boards of Universities and Colleges
Association of Jesuit Colleges and Universities
Council of Graduate Schools
Council of Independent Colleges
Hispanic Association of Colleges and Universities
National Association of College and University Business Officers
National Association of Independent Colleges and Universities
National Association of Student Financial Aid Administrators
National Association of State Universities and Land-Grant Colleges

American Financial Services Association

May 10, 1996

The Honorable William Archer
Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Chairman:

Pursuant to your request for written comments on new revenue provisions in the President's Fiscal Year 1997 Budget, the American Financial Services Association (AFSA) wishes to express its strong opposition to the provision titled, "Require Reasonable Payment Assumptions for Interest Accruals on Certain Debt Instruments", which in reality seems to cover only credit card receivables. The provision is an inappropriate departure from tax accrual standards and there is no basis for extending the prepayment assumptions currently applicable (for only limited purposes) to REMIC interests to credit card receivables in order to "equalize" the two types of significantly different instruments. AFSA is concerned both with the specific impact of the proposal on the credit card industry as well as the precedent it sets for further departures from long-standing tax law accrual standards. This is not an issue of "corporate welfare" or of closing a "loophole", but of whether or not for impacted tax payers in an arbitrary fashion purely to raise tax revenue.

Thank you for requesting comments and for considering our views on this important matter.

Sincerely,

Jeffrey A. Tassey
Senior Vice President
Government & Legal Affairs

Attachment

919 Eighteenth Street, N.W., Washington, D.C. 20006 Telephone: (202) 296-5544 *Fax: (202) 223-0321*

Comments of the American Financial Services Association on the New Revenue Provision in the President's Fiscal Year 1997 Budget that would "Require Reasonable Payment Assumptions for Interest Accruals on Certain Debt Instruments"

I. Summary of AFSA'S Position

The American Financial Services Association (AFSA) strongly opposes the new revenue proposal titled, "Require Reasonable Payment Assumptions for Interest Accruals on Certain Debt Instruments", which in reality seems to be directed toward unbilled, estimated interest on credit card receivables. The provision is an inappropriate departure from tax accrual standards and there is no basis for extending the prepayment assumptions currently applicable (for only limited purposes) to REMIC interests to credit card receivables in order to "equalize" the two types of significantly different instruments. AFSA is concerned both with the specific impact of the proposal on the credit card industry as well as the precedent it sets for further departures from long-standing tax law accrual standards. This is not an issue of "corporate welfare" or of closing a "loophole", but of whether or not the "all events" test can be selectively dispensed for impacted taxpayers in an arbitrary fashion purely to raise tax revenues. A more thorough discussion of the issue is found below followed by a description of AFSA's membership as required by the request for comments.

II. Background

Under present law, holders of credit card receivables recognize credit card interest income for tax purposes under the historic "all events test". Accordingly, any interest income that is both fixed and determinable is accrued currently. Any interest income, however, the right to which is contingent upon events outside the taxpayers control, is not includable in taxable income until all events occur which eliminate the contingency. This rule applies to interest related to a "grace period" provided to a credit card customer.

Under a typical grace period arrangement (please see the attached chart), a credit card customer can avoid any finance charge on year-end purchases by paying the outstanding balance on or before the payment due date (i.e., through a 25-day grace period). The customer will owe interest related to the period from the billing date through the end of the year only if the customer fails to pay the outstanding balance before the end of the grace period. As the credit card issuer's right to this "grace period interest" is not fixed until the end of the grace period, the issuer is not required to currently accrue any grace period interest which becomes fixed during the subsequent year.

III. The Administration's Revenue Proposal

Simply stated, the provision in President Clinton's Fiscal Year 1997 budget requiring prepayment assumptions for interest accruals would cause credit card issuers to pay tax on grace period interest before having a fixed right to the income. The proposal would require issuers to include currently in taxable income an estimate of the amount of grace period interest that will accrue in the future. This estimate would be based on the credit card issuer's assumptions of the likelihood that its credit card customers will not pay their entire balance before the end of the applicable grace period. If, in the attached example, the taxpayer assumed, based on experience, that 50 percent of all nominal grace period interest becomes fixed, the taxpayer would, under the budget proposal, have to accrue for 1995 50 percent of the estimated grace period interest on the $1,000 balance outstanding at December 31, 1995, or $3.50.

IV. Why the Revenue Proposal's Departure from Tax Accrual Standards is Inappropriate and Why REMICS are not Comparable Instruments

The Treasury Department claims that prepayment assumptions currently applicable to REMIC interests should be extended to credit card receivables in order to "equalize" the treatment of these two types of instruments. This goal is misplaced, however, because prepayment assumptions are used under present law only for the limited purpose of accruing discount and premium on REMIC interests, but are not used for accruing stated interest. Instead, stated interest on debt instruments (including credit card receivables) is accrued under the historic "all events test" whereby taxpayers pay federal income tax on taxable income determined by reducing fixed and determinable income by fixed and determinable expenses. A consistent application of the fixed and determinable standard to both income and expense preserves the integrity and fairness of the system even though some income or expense items may be taken into account at different times for financial statement purposes. Accrual method taxpayers are not entitled to deduct estimates of future expenses (such as bad debts) which, based on experience, are highly likely to be incurred. Predictions of uncertain future events have long been rejected as a basis for tax accounting on both the income and the expense side. In fact, since 1984 the accrual of expenses has been deferred beyond the time that they are fixed and determinable. A further one-sided departure from the historic "all events test" will significantly distort taxable income solely for the sake of a onetime revenue raiser.

V. Conclusion

Under no circumstances can present law be viewed as a "loophole" or as providing "corporate welfare." On the contrary, adopting the proposal in question can only be viewed as a tax increase on a selected group of taxpayers. AFSA believes that the proposal is not only an undesirable departure from well established tax policy, but is also inequitable and one-sided.

Attachment

AFSA believes that the logic expressed by the Joint Committee on Taxation in its explanation (see below) of the repeal of the deduction for bad debt reserves in the 1986 Act holds equally to grace period interest. The conclusion of the explanation states that if a deduction is allowed prior to the taxable year in which the bad debt loss actually occurs, the tax liability of the taxpayer is understated. Conversely, if grace period interest must be recognized before the right to receive such income by a credit card issuer is actually fixed, its tax liability will be overstated.

Further, the proposal suffers from the same defects that the staff of the Joint Committee on Taxation relied on as the basis for the repeal of the deduction for bad debt reserves in the 1986 Act:

F. Reserve for Bad Debts (Sec. 805 of the Act and sec. 166 of the Code) [91]

Prior Law

Prior law permitted taxpayers to take a deduction for losses on business debts using either the specific charge-off method or the reserve method. The specific charge-off method allows a deduction at the time and in the amount that any individual debt is wholly or partially worthless. The reserve method allows the current deduction of the amount that is necessary to bring the balance in the bad debt reserve account as of the beginning of the year, adjusted for actual bad debt losses and recoveries, to the balance allowable under an approved method as of the end of the year. The deduction taken under the reserve method is required to be reasonable in amount, determined in light of the facts existing at the close of the taxable year.

Worthless debts are charged off, resulting in a deduction under the specific charge-off method, or an adjustment to the reserve account under the reserve method, in the year in which they become worthless. In the case of a partially worthless debt, the amount allowed to be charged off for Federal income tax purposes cannot exceed the amount charged-off on the taxpayer's books. No such requirement is applicable to wholly worthless debts.

Prior law required an actual debt be owed to the taxpayer in order to support the creation of a reserve for bad debts. An exception to this rule was provided for dealers who guarantee, endorse or provide indemnity agreements on debt owed to others if the potential obligation of the dealer arises from its sale of real or tangible personal property.

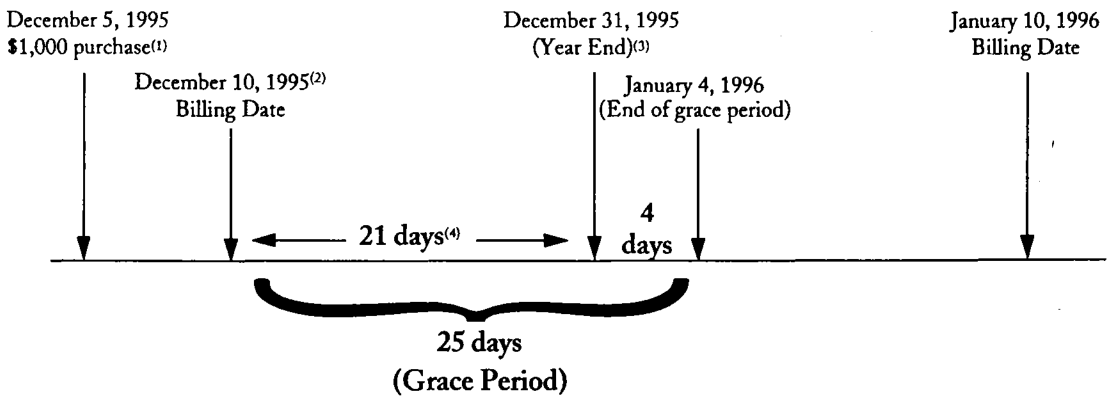
Reasons for Change

The Congress believed that the use of the reserve method for defining losses from bad debts resulted in the deductions being allowed for tax purposes for losses that statistically occur in the future. Thus, the Congress believe that the use of the reserve method for determining losses from bad debts allowed a deduction to be taken to the time that the loss actually occurred. This treatment under prior law was not consistent with the treatment of other deductions under the all events test. If a deduction is allowed prior to the taxable year in which the loss actually occurs, the value of the deduction to the taxpayer is overstated and the overall tax liability of the taxpayer understated. (emphasis added)

[91] For legislative background of the provision see H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 906, H. Rep. 99-426, pp. 638-641; H.R. 3838 as reported by the Senate Committee on Finance on May 29, 1986, sec. 303; S. Rep. 99-313, pp. 153-158 and H. Rep. 99-841 Vol. II (September 18, 1986) pp. 314-316 (Conference Report)

The administration's current revenue proposal applies to credit card issuers' receivables for which the above provision of the 1986 Act repealed the deduction for bad debt reserves. While the repeal of the bad debt deduction in 1986 relied on the "all events" test to prevent issuers of credit card receivables from using statistical data for purposes of accruing bad debt deductions, for income purposes the Administration is now willing -- for income purposes only -- to rely on statistics to require income inclusions with respect to the same credit card receivables.

Grace Period Interest Example



Assumptions/Notes

(1) Cardmember makes purchase on 12/5 on credit card which provides for 12% interest rate and 25 day grace period.

(2) Cardmember's monthly billing date is 10th.

(3) Card issuer is a calendar year taxpayer.

(4) Grace period interest on a 12% credit card = $1,000 x 12% = $120/12 (months) = $10 x 21/30 = $7.00.

The American Financial Services Association

The American Financial Services Association (AFSA) is the trade association for a wide variety of non-traditional, market-funded providers of financial services to consumers and small businesses.

AFSA's members fit into four basic categories:

- Diversified Financial Services Companies — These are companies that offer a broad range of financial services and products to consumers nationwide. Many of these members are affiliated with banks or savings and loans.

- Automotive Finance Companies — These companies are frequently referred to as "captive finance companies," they provide financing for customers that purchase the manufacturer's products. In addition, many of the companies or their parents have branched out into a range of other financial services, such as credit cards or mortgage lending.

- Consumer Finance Companies — The core business of this membership segment includes: unsecured personal loans, home equity loans, and sales financing (for retailers' credit customers). This segment includes companies of all sizes.

- Credit Card Issuers — This membership segment offers bank cards, charge cards, credit cards or private label cards. AFSA members include many of the largest credit card issuers in the U.S.

AFSA members are important sources of credit to the American consumer, providing between 10 and 15 percent of all consumer credit. AFSA members are highly innovative and compete at all levels in the financial services markets. Our members have charged AFSA with promoting a free and open financial services market that rewards the highest level of competitiveness.

**COMMENTS OF THE
AMERICAN PETROLEUM INSTITUTE
ON NEW REVENUE PROVISIONS
IN THE PRESIDENT'S FISCAL 1997 BUDGET
SUBMITTED FOR THE
PRINTED RECORD OF THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES**

The American Petroleum Institute (API) represents approximately 300 companies involved in all aspects of the oil and gas industry, including exploration, production, transportation, refining, and marketing. API members are among the leaders in the global oil and gas business. API appreciates the opportunity to comment on the proposed changes in the '97 Budget of: I. The taxation of foreign oil and gas income; II. The foreign tax credit carryover rules; and III. Certain excise taxes affecting the industry (hereafter separately or collectively referred to as the Proposal).

I. MODIFICATION OF THE TAX RULES APPLICABLE TO THE FOREIGN TAX CREDIT AND "FOREIGN OIL AND GAS INCOME"

(Secs. 9565 and 9566 of "Title IX--Revenue" of the President's FY 1997 Budget, Submitted 3/19/96)

BACKGROUND

President Clinton's latest budget proposal includes some significant changes to the foreign tax credit ("FTC") rules impacting companies with foreign oil and gas extraction income ("FOGEI") as defined by Code Section 907(c)(1), and foreign oil related income ("FORI") as defined by Code Section 907(c)(2). Specifically, the proposal includes the following provisions:

- Effective for taxable years beginning after the bill's enactment, so-called "deferral" would be repealed for all "foreign oil and gas income" ("FOGI"). FOGI would be treated, instead, as Subpart F income as defined under Code Section 952 (i.e., not eligible for deferral), and trapped in a new separate FOGI basket under Code Section 904(d). FOGI would be defined to include both FOGEI and FORI.

- In situations where taxpayers are subject to a foreign tax and also receive an economic benefit from the foreign country, taxpayers would only be able to claim a credit for such taxes under Code Section 901 if the country has a "generally applicable income tax" that has "substantial application" to all types of taxpayers, and then only up to the level of taxation that would be imposed under the generally applicable income tax.

- Despite these changes, U.S. treaty obligations that allow a credit for taxes paid or accrued on FOGI would continue to take precedence over this legislation (e.g., the so-called "per country" limitation situations).

Following is a detailed discussion of these changes and their expected effect on the taxation of FOGI.

DISCUSSION

INTRODUCTION AND TRADE ARGUMENTS

The proposed changes to the FTC rules for FOGI and the repeal of so-called "deferral" (i.e., current taxation of foreign subsidiary income before distribution) conflict with the Clinton Administration's announced trade policy. The Administration has demonstrated an intention to subscribe to the integration of worldwide trade, with a continuing removal of trade barriers and promotion of international investment (e.g., the GATT and NAFTA agreements). Moreover, because of their political and strategic importance, foreign investments by U.S. oil companies have been welcomed by the U.S. government. For example, recent participation by U.S. oil companies in the development of the Tengiz oil field in Kazakhstan has been praised as fostering the political independence of that newly formed nation, as well as securing new sources of oil for Western nations, which are still too heavily dependent on Middle Eastern imports. (*See* the April 28, 1996 Washington Post, at p. A-20).

Curiously, given this background, the Administration's proposals will further tilt "the playing field" against the U.S. petroleum industry's foreign exploration and production efforts, and will increase, or make prohibitive, the U.S. tax burden on foreign petroleum industry operations. They will not only stymie new investment in foreign exploration and production projects, but also change the economics of past investments. As illustrated in the example below, the proposed changes in the FTC rules would likely reduce the return on project investments by approximately one-third.

This proposed additional tax burden, like other barriers to foreign investments by U.S. firms, is based on several flawed premises. For example, there is the perception that foreign investment by U.S. business is responsible for reduced investment and employment in the U.S. These investments are perceived to be made primarily in low wage countries at the expense of U.S. labor; with such foreign investments also including a shift of Research & Development ("R&D") spending abroad. However, studies like the 1995 review by the Economic Strategy Institute (Multinational Corporations and the U.S. Economy [1995]) show these claims to be unfounded. Over a 20-year period, capital outflows from the U.S. averaged less than 1% of U.S. nonresidential fixed investment, which is hardly sufficient to account for any serious deterioration in U.S. economic growth. Instead, affiliate earnings and foreign loans, not U.S. equity, have financed the bulk of direct foreign investment.

Contrary to another perception, the principal reason for foreign investment is seldom cheap labor. Rather, the more common reasons are a search for new markets, quicker and easier response to local market requirements, elimination of tariff and transportation costs, faster generation of local good will, and other deep rooted host country policies. In this regard, the bulk of U.S. foreign investment is in Europe, where labor is expensive, rather than in Asia and Latin America, where wages are low. According to a recent study, almost two-thirds of employment by foreign subsidiaries of U.S. companies was in Canada, Japan, and Europe, all higher wage areas (Sullivan, From Lake Geneva to the Ganges: U.S. Multinational Employment Abroad, 71 Tax Notes 539 [4/22/96]). Although some R&D functions have been moved abroad, they make up only 15 % of domestic R&D, and are primarily in areas aimed at tailoring products to local demands. Moreover, two recent studies of the OECD countries conclude that foreign investment is beneficial to employment and incomes in both the home and host countries. (The OECD Countries, Paris [1994]; Trade and Investment: Transplants, Paris [1994]).

In the case of natural resource extraction and production, the reason for foreign investment is obvious. If U.S. oil and gas concerns wish to stay in business, they must look to replace their diminishing reserves overseas, since the opportunity to do so in the U.S. has been restricted by both federal and state government policy. If U.S. companies can not legitimately compete, foreign resources will instead be produced by foreign competitors, only then without any benefit to the U.S. economy, and without U.S. concerns or American workers deriving any direct or indirect income from the foreign production activity.

The FTC principle, along with so-called "deferral" of taxation of foreign subsidiary earnings until repatriation (see discussion below), make up the foundation of U.S. taxation of foreign source income. These proposals would destroy these basic rules of foreign income taxation on a selective basis for foreign oil and gas income only, in direct conflict with the U.S. trade policy of global integration, embraced by both Democratic and Republican Administrations.

FOREIGN TAX CREDIT CHANGES

THE FTC IS INTENDED TO PREVENT DOUBLE TAXATION

Since the beginning of Federal income taxation, the U.S. has taxed the worldwide income of U.S. citizens and residents, including U.S. corporations. To avoid double taxation, the FTC was introduced in 1918. Although the U.S. cedes primary taxing jurisdiction for foreign income to the source country, the FTC operates by preventing the same income from being taxed twice. The FTC is designed to allow a dollar for dollar offset against U.S. income taxes for taxes paid to foreign taxing jurisdictions.

Under this regime, foreign income of foreign subsidiaries is not immediately subject to U.S. taxation. Instead, the underlying earnings become subject to U.S. tax only when the U.S. shareholder receives a dividend (other than certain "passive" or "Subpart F" income). Any foreign taxes paid by the subsidiary on such earnings is deemed to have been paid by any

U.S. shareholders owning at least 10 % of the subsidiary, and can be claimed as FTCs against the U.S. tax on the foreign dividend income (the so-called "indirect foreign tax credit").

BASIC RULES OF THE FTC

The FTC is intended to offset only U.S. tax on foreign source income. Thus, an overall limitation on currently usable FTCs is computed by taking the ratio of foreign source income to worldwide taxable income, and multiplying this by the tentative U.S. tax on worldwide income. The excess of FTCs can be carried back 2 years and carried forward 5 years, to be claimed as credits in those years within the same respective overall limitations.

The overall limitation is computed separately for various "separate limitation categories." Under present law, FOGI falls into the general limitation category, i.e., for purposes of computing the overall limitation, FOGI is treated like any other foreign active business income. Separate special limitations still apply, however, for income: (1) whose foreign source can be manipulated; (2) which typically bears little or no foreign tax; or (3) which often bears a rate of foreign tax that is abnormally high or in excess of rates of other types of income. In these cases, a separate limitation is designed to prevent the use of foreign taxes imposed on one category to reduce U.S. tax on other categories of income.

FTC LIMITATIONS FOR OIL AND GAS INCOME

In response to the development of high tax rate regimes by "OPEC", taxes on FOGI have become the subject of special limitations. For example, each year the amount of taxes on FOGEI may not exceed 35 % (i.e., the U.S. corporate tax rate) of such income. Any excess may be carried over like excess FTCs under the overall limitation. FOGEI is income derived from the extraction of oil and gas, or from the sale or exchange of assets used in such efforts. In addition, the IRS has regulatory authority to determine that a foreign tax on FORI is not "creditable" to the extent that the foreign law imposing the tax is structured, or in fact operates, so that the tax that is generally imposed is materially greater than the amount of tax on income that is neither FORI or FOGEI. FORI is foreign source income from (1) processing oil and gas into primary products, (2) transporting oil and gas or their primary products, (3) distributing or selling such, or (4) disposing of assets used in the foregoing activities. Otherwise, the overall limitation (with its special categories discussed above) applies to FOGEI and FORI. Thus, as active business income, FOGEI and FORI would fall into the general limitation category.

THE DUAL CAPACITY TAXPAYER SAFE HARBOR RULE

As distinguished from the rule in the U.S. and some Canadian provinces, mineral rights in other countries vest in the foreign sovereign, which then grant exploitation rights in various forms. This can be done either directly or through a state owned enterprise (e.g., a license or a production sharing contract). Because of this apparent direct or indirect economic identity of taxing sovereign and grantor of mineral exploitation rights, the high tax rates imposed on oil and gas profits have often been questioned as representing, in part, payment for the grant of "specific economic benefits" from mineral exploitation rights. Thus, the dual nature of these payments to the sovereign have resulted in such taxpayers being referred to as "dual capacity taxpayers."

To help resolve controversies surrounding the nature of tax payments by dual capacity taxpayers, the Treasury Department developed the "dual capacity taxpayer rules" of the FTC regulations. Under the facts and circumstances method of these regulations, the taxpayer must establish the amount of the intended tax payment that otherwise qualifies as an income tax payment but is not paid in return for a specific economic benefit. Any remainder is a deductible rather than creditable payment (and in the case of oil and gas producers, are considered royalties). The regulations also include a safe harbor election (*see* Treas. Reg. § 1.901-2A(e)(1)), whereby a formula is used to determine the tax portion of the payment to the foreign sovereign, which is basically the amount that the dual capacity taxpayer would pay under the foreign country's general income tax. Where there is no generally applicable income tax, the safe harbor rule of the regulation allows the use of the U.S. tax rate in a "splitting" computation (i.e., the U.S. tax rate is considered the country's generally applicable income tax rate).

THE PROPOSAL LIMITS FTCs OF DUAL CAPACITY TAXPAYERS TO THE HOST COUNTRY'S GENERALLY APPLICABLE INCOME TAX

If a host country that had an income tax on FOGI (i.e., FOGEI or FORI), but no generally applicable income tax, were to ignore the effect that its tax regime has on the new FTC position of U.S. companies, the proposal will result in disallowing any FTCs on FOGI. This would result in inequitable and destructive double taxation of dual capacity taxpayers, contrary to the global trade policy advocated by the U.S.

The inequity becomes even more obvious if one considers the situation where a dual capacity taxpayer and a taxpayer which is not a dual capacity taxpayer are subject to an income tax in country without a generally applicable income tax. Under the proposal, only the dual capacity taxpayer would receive no foreign tax credit, while the other taxpayer would be entitled to the full tax credit for the very same tax.

The additional U.S. tax on foreign investment in the petroleum industry would not only eliminate many new projects; but may also change the economics of past investments. In some cases, this will not only reduce the rate of return, but also preclude a return of the investment itself, leaving the U.S. business with an unexpected "legislated" loss. In addition, because of the uncertainties of the provision, it will also introduce more complexity and potential for litigation into the already muddled world of the FTC.

The proposal's concerns with the tax versus royalty distinction were resolved by Congress twenty years ago with the special tax credit limitation on FOGEI, which was then reinforced by the fragmentation of foreign source income from the 1986 Act into a host of categories or baskets. The earlier solution of the tax versus royalty dilemma recognized that (1) if payments to a foreign sovereign meet the criteria of an income tax, they cannot be denied complete creditability against U.S income tax on the underlying income; and (2) creditability of the perceived excessive tax payment is better controlled by reference to the U.S. tax burden, instead of being dependent on the foreign sovereign's fiscal choices, such as enacting an income tax on all income that applies to all persons, according to U.S. criteria.

THE PROPOSAL LIMITS FTCs TO THE AMOUNT WHICH WOULD BE PAID UNDER THE GENERALLY APPLICABLE INCOME TAX

By elevating the regulatory safe harbor to the exclusive statutory rule, the proposal eliminates a dual capacity taxpayer's right to show, based on facts and circumstances, which portion of its payment to the foreign government was not made in exchange for the conferral of specific economic benefits and, therefore, qualifies as a creditable tax. Moreover, by eliminating the "fall back" to the U.S. tax rate in the safe harbor computation where the host country has no generally applicable income tax, the proposal denies the creditability of true income taxes paid by dual capacity taxpayers under a "schedular" type of business income tax regime (i.e., regimes which tax only certain categories of income, according to particular "schedules"), merely because the foreign sovereign's fiscal policy has chosen not to include all types of business income.

For emerging economies of lesser developed countries, as for post-industrial nations, it is not realistic to always demand the existence of a generally applicable income tax. Even if the political willingness exists to have a generally applicable income tax, such may not be possible because the ability to design and administer a generally applicable income tax depends on the structure of the host country's economy. The available "tax handles" are defined by the country's economic maturity, business structure and accounting sophistication. The most difficult problems arise in the field of business taxation. One has to remember that a business profits tax presupposes that business accounting has been developed to measure profits adequately. Oftentimes, the absence of reliable accounting books will only allow a primitive presumptive measure of profits. Under such circumstances the effective administration of a general income tax is impossible. All this is exacerbated by phenomena which are typical for less developed economies: a high degree of self-employment, the small size of establishments, and low taxpayer compliance and enforcement. In such situations, the income tax will have to be limited to mature businesses, along with the oil and gas extraction business.

THE PROPOSAL INCREASES THE RISK OF DOUBLE TAXATION

Adoption of the Administration's proposals would further tilt the playing field against overseas oil and gas operations by U.S. business, and increase the risk of double taxation of FOGI. This will severely hinder U.S. oil companies in their competition with foreign owned oil and gas concerns in the global oil and gas exploration, production, refining, and marketing arena, where the home countries of their foreign competition do not tax FOGI. This occurs where these countries either exempt foreign source income or have a liberal foreign tax credit regime which truly prevents double taxation.

To illustrate, assume foreign country X offers licenses for oil and gas exploitation and also has an 85 % tax on oil and gas extraction income. In competitive bidding, the license will be granted to the bidder which assumes exploration and development obligations most favorable to country X. Unless a U.S. company is assured that it will not be taxed again on its after-tax profit from country X, it very likely will not be able to compete with another foreign oil company for such a license because of the different after tax returns.

EXAMPLE

	U.S. OWNED OIL COMPANIES		FOREIGN COMPETITORS
Host Country Taxation			
Taxable profit	100		100
Host Country Tax	-85		-85
After Host Country Tax	15		15
Home Country Taxation	US Present Law	US Proposed	Foreign Competitor's Home Country Tax
Taxable Profit	100	100	Not Applicable because foreign income not taxed
Foreign Tax deduction	No, because credit claimed	-85	
Taxable Income	100	15	
Tentative Tax (e.g., U.S. tax at 35%)	35	5.25	
FTC limited to US tax on foreign source income	-35	N/A	
Home Country Tax payable	0	5.25	
Profit after Tax payments			
Profit before taxes	100	100	100
Tax to Host Country	-85	-85	-85
Tax to Home Country	0	-5.25	0
After Tax Profit	**15**	**9.75**	**15**

Because of the 35 % additional U.S. tax, the U.S. company's after tax return will be more than one-third less than its foreign competitor's. Stated differently, if the foreign competitor is able to match the U.S. company's proficiency and effectiveness, the foreigner's return will be more than 50 % greater then the U.S. company's return. This would surely harm the U.S. company in any competitive bidding. Only the continuing existence of the FTC, despite its many existing limitations, assures that there will be no further tilting of the playing field against U.S. companies' efforts in the global petroleum business.

SEPARATE LIMITATION CATEGORY FOR FOGI

To install a separate FTC limitation category for FOGI would single out the active business income of oil companies and separate it from the general business income "basket." However, there appears to be no legitimate reason to carve out FOGI from the general limitation category or basket. The source of FOGI is difficult to manipulate: FOGEI is derived from the country where the natural resource is in the ground while FORI is derived from the country where the processing or marketing occurs. Moreover, any FORI that is subject to manipulation is very likely taxed currently, before distribution, under the anti-avoidance rules for undistributed earnings of foreign subsidiaries.

REPEAL OF SO-CALLED DEFERRAL

BACKGROUND

As stated above, the U.S. exercises worldwide taxing jurisdiction over U.S. persons, including U.S. corporations. However, foreign corporations are not creatures of U.S. law and are thus not subject to US income tax (at least not immediately). The earnings of CFCs are taxed currently only by the host country. They are taxed to the U.S. shareholder only if and when distributed as a dividend.

Thus, taxing the U.S. shareholder on all or part of the foreign corporation's earnings, before dividends are distributed, is the exception rather than the rule. In the corporate context, the norm is that although U.S. corporations are taxed on their worldwide income, there is no taxation before realization. Accordingly, there is no taxation of the earnings of foreign subsidiaries before they are received in the form of a dividend, or before disposing of the subsidiary's stock. This is symmetrical with individual shareholders not being taxed on earnings from companies in which they own shares until dividends are declared and paid.

However, if the US shareholder is suspected of using a foreign subsidiary for "tax deferral", then, as in other cases of perceived tax avoidance, the Code provides for current taxation of such suspect earnings, imputing a constructive distribution. These rules are found in "Subpart F", and the income to the U.S. shareholder from these deemed distributions is conveniently referred to as "Subpart F income." Such abuse is generally seen only with respect to passive income or income which can be easily manipulated to sources with no or low foreign taxes. These abuse rules, referred to as "anti-deferral" rules, are portrayed as denying the "privilege of deferral." However, they operate more in the nature of penalty provisions, rather than by conferring or denying a privilege. Other countries have a few tax avoidance rules for current taxation of undistributed earnings of foreign subsidiaries (e.g., *see* Joint Committee on Taxation, Comparison of the Tax Systems of the United States, The United Kingdom, Germany, and Japan [JCS-13-92]). By contrast, the Subpart F rules have grown into an elaborate, obfuscated network of provisions that extend beyond the repeatedly declared focus of current taxation of undistributed foreign earnings, i.e., low taxed income or portable income.

THE PROPOSAL STATES NO REASON FOR SINGLING OUT FOGI FOR SUBPART F TREATMENT

As stated above, Subpart F treatment is generally limited to passive income that is easily manipulated as to source or income, or that is earned in low or no income jurisdictions. The Administration's proposal does not indicate the perceived suspect nature of FOGI. It is clear that none of the typical rationales for Subpart F treatment applies to FOGI For example, FOGI is not passive income but, rather, very active income from the exploration, production, refining, and marketing of petroleum and its primary products; FOGI's source is not easily manipulated since it is determined by nature; and, FOGI is not earned in a low or no income tax jurisdiction.

Undistributed earnings of foreign subsidiaries should only be taxed to the U.S. shareholder where foreign earnings can be manipulated as to source or taxing jurisdiction, with a concomitant potential of U.S. tax avoidance. It is the potential for tax avoidance that calls for an exception from the fundamental principle. As active business income, FOGI is derived where and when the natural resource is extracted, without any tax manipulation intention.

Moreover, current taxation of foreign subsidiaries' FOGI will exacerbate the differences between the host country and U.S. tax laws. This may result in an additional U.S. tax burden, curtailing or crippling the competitiveness of U.S. oil companies. As a general rule, the host country tax burden on a project is greater than the U.S. tax burden. Thus, in an ideal world, even current taxation of a CFC's earnings would not result in an additional U.S. tax burden. However, differences in the host country and U.S. tax laws, such as the timing of cost recovery, and the many restrictions in the U.S. tax credit mechanism, will frequently result in additional U.S. tax even though the cash flow is reinvested in the host country or region. Under present law, the U.S. shareholder can, as part of its dividend policy, mitigate this potential for double taxation to some extent. However, the proposal would eliminate this tool and tax the U.S. shareholder on the earnings of the foreign subsidiary, without regard to a distribution, and without regard to the timing of the foreign tax incidence or the actual cash flow.

THE PROPOSALS ARE BAD TAX POLICY

Reduction of U.S. participation in foreign oil and gas development will adversely affect U.S. employment, and any additional tax burden may hinder the U.S. company in its competition with foreign concerns. Although the host country resource will be developed, it will be done by foreign competition, with the adverse ripple effect of U.S. jobs losses and the loss of continuing evolution of U.S. technology. By contrast, foreign oil and gas development by U.S. companies assures utilization of U.S. supplies of hardware and technology, The loss of any major foreign project to a U.S. company will mean less employment in the U.S. by suppliers, and by the U.S. parent, in addition to fewer U.S. expatriates at foreign locations.

Foreign operations are not placed into foreign subsidiaries merely for tax reasons. Although current taxation of undistributed subsidiary earnings is oftentimes justified by the claim that the taxpayer's choice of operating in the host country through a U.S. company versus a foreign company should not affect the U.S. tax burden, such analysis is flawed. Choice of a foreign corporation as the vessel for doing business in the host country generally is for business reasons, e.g., the utilization of a host country company may be required for natural resources extraction.

II. MODIFICATION OF THE FOREIGN TAX CREDIT CARRYOVER RULES

(Sec. 9564 of "Title IX-Revenue")

For FTCs in excess of the overall limitation, the proposal would reduce carryback periods from two to one year and extend the carryforward from five to seven years. This is based on the perception that carrybacks were associated with increased complexity and administrative burdens, as compared to carryforwards.

This proposal increases the risk of losing utilization of excess credits effectively due to the reduction of the carryback period; this disadvantage is not offset by the extension of the carryforward period. As a substitute for the proposal, the FTC carryover rules should be aligned with the rules applicable to other tax attributes like Net Operating Losses (NOL) and Business Tax Credits (i.e., 3 years carryback and 15 years carryforward, in total 18 years carryover).

Liberal carryover periods are of even greater importance for FTCs because of variances in foreign and domestic tax rules which result in timing differences of the foreign and domestic tax incidence, with a mismatch of foreign and U.S. tax under the FTC rules. Finally the fragmentation of the foreign income streams in the 1986 Act into nine or more baskets makes a liberalization in an alignment with the carryover rules for other tax attributes even more imperative.

III. EXCISE TAXES

API also wishes to comment on the following excise tax provisions contained in the President's fy 1997 budget:

Extension of the excise taxes deposited in the Hazardous Substance Superfund Trust Fund.

NO REAUTHORIZATION WITHOUT REFORM

The President proposes reinstating the Superfund excise taxes from date of enactment through October 1, 2006, and the Corporate Enrivonmental Tax for taxable years beginning after December 31, 1995 and before January 1, 2007. API opposes reauthorization of the Superfund taxes without substantial reform of the current tax system and the underlying Superfund program.

When the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) was enacted in 1980, Congress envisioned a program that would cost $1.6 billion and be complete within five years. Sixteen years later, however, billions have been spent, but few sites on the National Priorities List have been cleaned up. Absent major changes in the current law, it appears the program will be without end. Serious program reform efforts are underway in the Congress, and reauthorization of the taxes prior to completion of that work will only diminish the likelihood that real reform will be accomplished.

Furthermore, the tax regime enacted to fund the CERCLA program needs to be revised to make it more equitable. Under the present system, the petroleum industry, which is estimated to be responsible for roughly 10 percent of Superfund cleanup liability, pays over 50% of the Superfund taxes. There is clearly no connection between the petroleum industry's large tax burden and its relatively small contribution to the problem. Superfund sites are a broad societal problem, and taxes raised to remediate these sites should be broadly based rather than focused on a specific industry.

TECHNICAL AMENDMENTS

When the Committee considers reform of the Superfund taxes, if the excise taxes are retained, API wishes to propose several technical changes. With regard to the Petroleum Tax, we propose the following:

1. **Change the point of taxation on imported crude oil** from point of importation to receipt at a refinery. This would make it consistent with the point of taxation for domestic crude oil.

2. **Modify IRC Section 4611(b) to eliminate the provision that imposes the petroleum tax on crude oil exported from the United States**. The courts have interpreted the export clause (Article 1, Section 9, Clause 5 of the United States Constitution) to prohibit the federal government from imposing any tax or duty upon exports. However, as long as the language exists in the statute, the Internal Revenue Service is compelled to issue an assessment for failure to pay the tax on an export, thus forcing a taxpayer to incur expensive litigation to avoid paying an invalid tax.

3. **Modify the definition of "petroleum product"** for purposes of the Section 4611 Petroleum Tax to ensure that none of the listed petrochemicals under the Section 4661 Chemical Tax are subject to double taxation. API would be pleased to work with the staff of the Committee to develop an appropriate definition.

4. A controversy has developed with regard to the **taxation of natural gasoline under the Petroleum Tax**. The IRS has taken the position that the term "United States refinery" includes "any facility in the United States in which natural gasoline is produced by fractionation or similar operation." Thus, under that interpretation natural gasoline produced at a gas processing plant by fractionation or similar operation is subject to the tax at the plant. Taxpayers have challenged that interpretation, arguing that Congress never intended a gas processing plant to be defined as a refinery. In a recent decision (Enron Gas Processing Company v. United States of America) the court for the Southern District of Texas found in favor of the taxpayer. The IRS is considering whether to appeal that decision.

If the Congress decides to clarify the tax treatment of natural gasoline by amending the statute, the API urges that whatever position is adopted should be prospective only. To make any change retroactive would create a nightmare of tax liabilities and refunds for both taxpayers and the Service.

5. **Allow a refund or credit of the Section 4611 Petroleum Tax paid with respect to crude oil or petroleum products used to manufacture or produce exported motor fuel** under rules similar to those applied to chemicals under Section 4662(e). This would complement the exemption for exported derivative chamicals that has been in the law since

1987 and would be consistent with the Congressional policy underlying that exemption of making United States producers more competitive in world markets.

With regard to the Section 4661 Chemicals Tax, the API proposes two technical amendments:

1. **Clarify the application of the Chemicals Tax in those situations where a taxable chemical makes up only a part of a hydrocarbon stream** by adding the following new subparagraph (c) to Section 4661:

> 4661(c). The tonnage of a taxable chemical sold
> or used is computed on a contained weight basis.

While the statute appears clear on its face that the tax applies only to the contained weight of a taxable chemical, and regulations proposed October 23, 1983 (subsequently withdrawn for unrelated reasons) mirrored this clear intent, the IRS has now taken the position on audit that the tax is imposed on the full hydrocarbon stream including any non-taxable chemicals contained therein. "The IRS has also issued a Technical Advice Memorandum holding that a mixed olefin stream consisting of approximately 75% propylene (a taxable chemical) and 25% propane (a non-taxable chemical) is taxable as though it were 100% propylene." To put these issues to rest and avoid unnecessary litigation, the API urges the adoption of the language indicated above.

2. **Clarify determination of tax paid on chemicals to produce exported taxable substances.** Chemicals taxed under Section 4661 are often used as raw material in the manufacture or production of a substance. Provided such substance has been determined to be a "taxable substance" under Section 4672(a), a credit or refund is allowable for the taxes paid on chemicals that have been used in the production or manufacture of the substance when the substance has been exported. Because manufacturing processes vary from producer to producer, and because these "taxable substances" are freely exchanged and sold between producers and then commingled in common storage, an issue has arisen with regard to determination of the amount of taxable chemical(s) eligible for the refund in any particular exported substance.

As a solution to this credit/refund problem, the IRS should utilize the same rate of tax as prescribed for the substance at the time it is added to the list of "taxable substances." API proposes that the following language be added to Section 4662(e):

> "Determination of tax paid on chemicals used to produce exported taxable substances. -- The amount of credit allowed or refund paid on taxable substances shall be computed by utilizing the rate of tax that was prescribed for such substance by the Secretary utilizing the predominant method of production.

Reauthorization of Oil Spill Liability Trust Fund Tax

The Administration proposes reinstating the Oil Spill Tax which expired December 31, 1994, and raising the Fund cap from $1 billion to $2.5 billion. This is despite the fact that the Administration's fy 1997 Budget indicates that there was over $1 billion in the Fund at the end of fy 1995 and that they project there will be $997 million in the Fund at the end of fy 1996 without any taxes being collected. Since its establishment in 1989, annual cash outlays from the Fund have never exceeded $170 million. Clearly, no new tax revenues are needed, and there is absolutely no reason to increase the cap. API opposes the Administration's proposal.

Kerosene Taxed as Diesel Fuel

Over the years, API has worked diligently with Congress and the Department of Treasury to reduce the evasion of motor fuels excise taxes by tax cheats. The 1993 Tax Act's change in the point of collection of the diesel tax and the requirement that diesel fuel be "taxed or dyed" constituted a substantial step forward in this effort. The Administration's proposal to define kerosene as diesel fuel, thereby subjecting it to the diesel tax or dye requirements would be an important additional step in reducing evasion of the federal excise tax on diesel fuel. API supports this proposal.

alhfa

ASSOCIATION OF LOCAL HOUSING FINANCE AGENCIES

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May 9, 1996

The Honorable Bill Archer
Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Chairman:

This letter is in response to your invitation to comment on tax proposals contained in the President's FY 1997 budget proposal. In particular, I wish to state the opposition of the Association of Local Housing Finance Agencies to the President's call for repeal of the 2% de minimis safe harbor with respect to corporate purchases of tax-exempt bonds. The budget pejoratively refers to the safe harbor as a form of "corporate welfare."

As you know, in 1972 the Internal Revenue Service established a "safe harbor" under which corporations may purchase and hold tax-exempt bonds in an amount not exceeding two percent of their assets without having to demonstrate to the Service that borrowed funds were not used (and therefore no interest expense deduction was taken) to purchase the bonds.

The de minimis rule has facilitated corporate involvement in the municipal bond market allowing corporations to play an important role by purchasing short and long-term securities, variable rate debt, and tax-exempt leases. Elimination of this safe harbor would have a serious negative impact to the ability of local governments to finance affordable housing, infrastructure, and other capital facilities and equipment, as it would dampen corporate demand, lead to an inefficient market and drive up borrowing costs.

With respect to affordable housing, Fannie Mae and Freddie Mac, often in partnership with other corporate investors, are major purchasers of state and local housing finance agency-issued Mortgage Revenue Bonds as well as variable rate multifamily bonds. When Fannie Mae purchases an entire MRB issue, a savings of approximately 2% of the face value of the bonds is realized by the issuer due to the absence of underwriting costs. This savings is passed along to first-time homebuyers in various forms such as downpayment assistance or reduced mortgage interest rates. Since 1987 when Fannie Mae began purchasing MRBs, it has purchased a total of $7.1 billion from state and local housing finance agencies. As a result of this investment, an estimated 120,000 low-and moderate-income families have achieved the dream of homeownership.

Mr. Chairman, we applaud your statement earlier this year expressing your strong opposition to the repeal of the 2% de minimis rule. We urge you to continue that opposition and help insure defeat of the Administration's proposal.

Sincerely,

John C. Murphy

John C. Murphy
Executive Director

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May 15, 1996

Phillip D. Moseley
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U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Revenue Provisions in the President's Fiscal Year 1997 Budget -- Dividends Received Deduction and Net Operating Loss Carryback

Dear Mr. Moseley:

In connection with Chairman Archer's request for public comments on the revenue provisions in President Clinton's fiscal year 1997 budget, we submit the following comments on behalf of a group of commercial banks that includes Bank of America, Bank of Boston, Chase Manhattan Bank, Citibank, First National Bank of Chicago, First Interstate Bank, Fleet Financial Corporation, Norwest Corporation, and Mellon Bank.

We urge the Committee to reject two of the tax proposals contained in the President's 1997 Budget: (1) The proposed reduction in the deduction for dividends received by a corporation, and (2) the proposed shortening of the period for the carryback of net operating losses to one year.

The corporate dividends received deduction and the net operating loss carryback are not "loopholes" or "subsidies" in any sense of those terms. Instead, their purpose is to prevent over taxation of income. The dividends received deduction is designed to prevent multiple-taxation of corporate earnings. The net operating loss carryback is designed to prevent the taxation of income artificially created by annual accounting, when income fluctuates from year to year.

These proposals, moreover, result in over taxation of business income and are therefore inimical to capital formation and economic growth.

Dividend Received Deduction

Corporations generally are eligible under current law for a deduction for dividends received. The purpose of this deduction is to prevent multiple taxation of corporate earnings as they are passed from one corporation to another. Ordinarily, corporate earnings are taxed twice, when earned and again when distributed to individual stockholders. Earnings are subject to a yet another level of tax, however, when distributed first to an intermediate corporate stockholder.

Section 243 of the Internal Revenue Code allows a corporation a deduction of 70% of dividends received if it owns less than 20% of the stock of the payor. The remaining 30% is subject to another level of corporate tax. This additional taxation of corporate earnings is compounded if earnings pass through additional corporations.

The Administration proposes to reduce the deduction to 50%.

Reducing further the dividend received deduction, as proposed by the President, would correspondingly increase the amount of corporate earnings subject to multiple taxation. In describing the reasons for its proposal, the Administration says only that the current 70% deduction is "too generous." This can be true only if multiple taxation of corporate earnings is viewed as appropriate. The Administration does not establish a basis for such a view.

Indeed, it is ironic that such a proposal should be made at a time when many of our major trading partners are moving toward integration of the corporate and individual income tax, reducing even the two layers of tax historically leveled on corporate earnings. The result of the Administration's proposal will be, without apparent justification, to reduce the return to capital and thus to increase the cost of capital for U.S. corporations, especially vis-a-vis their international competition.

Net Operating Loss Carryback

The Administration's proposed modification in the net operating loss carryback is similarly without justification.

Under current law, corporations are permitted to use net operating losses in a taxable year to offset income in the three preceding years. The purpose of this carryback is to permit the taxpayer to offset income and losses over a period of years, and so eliminate the disparity in tax liability between businesses with stable income and expense from year to year and businesses that experience fluctuations in income or expense. In this manner, businesses with the same income over time pay the same tax.

The Administration proposes to shorten the carryback period from three years to one. This will significantly reduce the ability of a business to offset expenses against income. The President's proposal to extend the future period for which current losses may be used to offset income does not compensate for the loss of the carryback. Losses recovered 20 years in the future have little worth, and are very unlikely, in any event, to bear any connection to the ordinary type of income fluctuations it was the purpose of the carryover rules to address.

For banks, the proposed limitation on the carryback period presents a special problem. Bank regulatory agencies in general will recognize for purposes of accounting for bank capital the value of a net operating loss -- or any other deferred tax asset -- only with respect to income anticipated in the next year. Therefore, any carryover of more than one year is meaningless for purposes of determining regulatory capital. The carryback, on the other hand, is recognized no matter the period. Therefore, the effect of the President's proposal is to shorten the effective regulatory carryover/carryback period for banks from four years to two. During difficult economic periods for banks, the result will be to reduce bank capital.

We submit that the Administration's proposals on the dividend received deduction and net operating loss carryback are ill-considered. The Committee ought to reject them

Sincerely yours,

John E. Chapoton
Thomas A. Stout, Jr.

Counsel for *Bank of America, Bank of Boston, Chase Manhattan Bank, Citibank, First Interstate Bank, First National Bank of Chicago, Fleet Financial Services, and Mellon Bank*

BEAR STEARNS

BEAR, STEARNS & CO. INC.

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May 14, 1996

Mr. Philip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Moseley:

In response to Chairman Archer's request, Bear Stearns & Co. Inc. is submitting a statement concerning two new tax provisions in President Clinton's Fiscal Year 1997 Budget. These provisions are: section 9512 of the Revenue Reconciliation Bill of 1996 (the "Bill"), which imposes constructive sale treatment on certain appreciated financial instruments; and section 9526 of the Bill, which modifies the holding period rules for the dividends received deduction (the "DRD").

The following is a summary of our comments. These provisions would penalize legitimate hedging transactions and adversely affect the financial markets. The scope of the constructive sale legislation is so broad that it covers many bona fide hedging transactions and would inhibit a broad range of other non-tax motivated transactions. We believe that narrowly drafted legislation can target potential abuses without adversely affecting legitimate hedging transactions and the financial markets. We also believe that the proposed DRD changes would penalize legitimate hedging transactions by imposing triple level taxation on distributions of corporate earnings. Current law is entirely adequate to ensure that the DRD is available only for economic investments.

Please do not hesistate to call if you have any questions. Our designated representatives are:

M. Lynn O'Neill	Eli Wachtel	Steven A. Weinstein
245 Park Avenue	245 Park Avenue	245 Park Avenue
New York, NY 10167	New York, NY 10167	New York, NY 10167
(212) 272-4197	(212) 272-4808	(212) 272-4780

Very truly yours,

BEAR STEARNS & CO. INC.

By:

Eli Wachtel
Senior Managing Director

Enclosure

STATEMENT OF BEAR STEARNS & CO. INC. CONCERNING PROPOSED CONSTRUCTIVE SALE AND DRD HOLDING PERIOD PROVISIONS

Summary

Two new tax provisions in President Clinton's Fiscal Year 1997 Budget would **penalize legitimate hedging transactions and adversely affect the financial markets**. These provisions are: section 9512 of the Revenue Reconciliation Bill of 1996 (the "Bill"), which imposes constructive sale treatment on certain appreciated financial instruments; and section 9526 of the Bill, which modifies the holding period rules for the dividends received deduction (the "DRD"). The scope of the constructive sale legislation is so broad that it covers many bona fide hedging transactions and would inhibit a broad range of other non-tax motivated transactions. We believe that narrowly drafted legislation can target potential abuses without adversely affecting legitimate hedging transactions and the financial markets. We also believe that the proposed DRD changes would penalize legitimate hedging transactions by imposing **triple level taxation on distributions of corporate earnings.** Current law is entirely adequate to ensure that the DRD is available only for economic investments.

Constructive Sale Provision

The Bill would treat a taxpayer as having made a constructive sale of an appreciated stock, debt instrument or partnership interest when the taxpayer "substantially eliminate(s)" both risk of loss and opportunity for gain "for some period". The basic problem with the proposed legislation is that it does not distinguish between legitimate hedging transactions and tax-motivated transactions. As a starting point, it must be stressed that management and reduction of risk for both businesses and investors should be encouraged and not penalized. Legislation which triggers tax on an appreciated financial position as a result of a non-tax motivated hedging transaction is simply bad tax policy.

The Bill does not provide a definition or guidance as to what triggers a constructive sale either in terms of: (1) what constitutes "substantial" elimination of risk of loss and opportunity for gain, or (2) what is the relevant "period" for such elimination. The provision appears to trigger a tax even if an investor hedges for only one day and thereafter retains all potential risk of loss and opportunity for profit.

Another major problem with the statutory framework is the difficulty in measuring potential risk of loss or opportunity for profit. In its report dated March 1, 1996, The New York State Bar Association suggested using option pricing or delta analysis as possible objective mechanisms for this purpose. However, as the NYSBA Report notes, different assumptions as to volatility, for example, will produce different results. More importantly, a statute that can be applied only by reference to sophisticated financial modeling not available to ordinary taxpayers or their advisors is patently unworkable.

Because of the sweeping scope of the proposed legislation, taxpayers who enter into a broad range of hedging transactions with respect to appreciated financial positions will be unable to determine whether such hedges trigger tax. These taxpayers will be reluctant to enter into legitimate, non-tax motivated hedging transactions because of the fear of triggering a current tax.

The chilling effect of the proposed legislation will have a negative impact on the stock and option markets. Many investors hedge a particular stock or all or a portion of a portfolio because of an economic event with respect to a specific company or general market conditions. The proposed legislation will likely cause many of these investors to choose to maintain their risk exposure rather than risk payment of a tax. The decrease in investor participation in the financial markets (especially the stock and options markets) will result in wider spreads and greater volatility in option and stock pricing. Ultimately, this will lead to less liquidity in the markets.

The following example illustrates the actual or potential application of the proposed legislation to legitimate, non-tax motivated hedging transactions. An employee may receive a significant portion of his compensation in the form of employee stock options, and the value of such options could comprise a meaningful component of the employee's net worth. If the employee is concerned about a potential general market decline or a specific event affecting his company or industry, the employee should be able to hedge a portion of his position without the fear of triggering a current tax.

The Treasury Department Explanation and JCT Description of the proposed legislation both refer to short sales as locking in gains on an appreciated stock. However, in most situations the potential for significant tax deferral from a short-against-the-box transaction is limited. The economic cost of a short-against-the box transaction generally will exceed the benefit of tax deferral **if the taxpayer maintains the short-against-the-box transaction for more than one year.** Therefore, there generally is no economic basis for long-term, short-against-the-box transactions, unless the investor intends to obtain a step-up in basis at death. See Appendix A for an illustration of this cost/benefit analysis.

The proposed legislation represents a dramatic change to current law. We urge Congress to carefully consider the impact this change would have on hedging practices and the financial markets. We believe that narrower legislation can address potential abuses that may exist under current law without impacting legitimate hedging transactions or adversely affecting the financial markets.

DRD Holding Period

Section 9526 of the Bill modifies the DRD holding period rules and would deny the DRD to a corporate shareholder that diminishes risk of loss within 45 days of the stock's ex-dividend date. The proposed change to the DRD holding period rules should not be enacted because it would have several major negative effects: (1) impose increased triple taxation of corporate earnings while many of the United States' major trading partners have moved to a system of single taxation of corporate earnings; (2) reduce participation in the options markets, resulting in increased volatility; and (3) increase the cost of capital for preferred stock issuers, especially in industries such as utilities in which preferred stock comprises a significant component of the capital structure. Finally, the proposed legislation is unnecessary because current law is adequate to ensure that the benefit of the DRD is available only for economic investments (as opposed to tax-motivated investments) in which the investor bears risk of loss for a meaningful period.

The United States has maintained its historical system of taxation whereby a corporation pays income tax on its corporate earnings and shareholders pay an additional tax upon distribution of earnings in the form of dividends. To minimize triple taxation of corporate earnings, U.S. corporations are allowed a 70-80% DRD for dividends received from other U.S. corporations.

The U.S. system of taxing corporate earnings should be compared to the tax systems of many of the United States' major trading partners such as Canada, England, France, Germany, Australia and New Zealand. These jurisdictions have an integrated system of taxation whereby corporate earnings are essentially subject to a single level of taxation. See January 1992 Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems Taxing Business Income Once.

By further limiting the availability of the DRD, the proposed legislation would increase the imposition of triple taxation on corporate earnings. Such triple taxation would result from a corporate tax being paid by the distributing corporation, a corporate tax paid by the recipient corporation, and a shareholder level tax. The proposed change to the DRD would result in a 74% tax on corporate level earnings before factoring in the additional cost of state and local taxes.

Example 1: A U.S. corporation ("Corporation A") earns $10000 and pays a U.S. federal income tax of $3500 on such earnings (35% tax rate). Corporation A distributes all of its earnings on a current basis and accordingly will distribute $65 to its 1% U.S. corporate shareholder ("Corporation B"). Corporation B has held the Corporation A stock for three years and plans to continue to hold the Corporation A stock for the indefinite future. However, Corporation B is concerned about the impact of a particular event on Corporation A and accordingly has purchased the right to put the Corporation A stock for 95% of its current fair market value in six months. Under the proposed change, Corporation B would not be eligible for the DRD and would pay a tax of $22.75 on such dividend (35% tax rate). Corporation B is owned by 10 individuals who are subject to tax at the highest U.S. marginal federal income tax rate of 39.6%. Such individual shareholders would collectively receive $42.25 in dividends and pay a collective tax of $16.83. Accordingly, such individual shareholders would collectively receive after-tax cash of $25.42, an effective tax rate of 74.5% on corporate earnings.[1]

The proposed legislation would also have a negative impact on the options markets. Market conditions often cause corporate investors to use various hedging techniques, especially through the use of options, to hedge a particular stock or all or a portion of a portfolio of stocks. These hedging transactions include cost-less collars (i.e., the purchase of an out-of-the-money put and the sale of an out-of-the-money call), the purchase of put options, and the sale of an "in-the-money" call that is more than one strike price in the money (i.e., non-qualified covered calls). The following examples are illustrative market-driven hedging transactions.

Example 2: Corporate investor purchases shares of Corporation X stock of July 13, 1995 for $50. On November 1, 1995, the stock price has dropped to $43/share and the investor believes that the stock prices will rebound to $50 but does not want to take the risk of significant further decline. To limit its future loss while retaining the upside, the investor purchases a June 1997 $40 put for 3 7/8 and sell as June 1997 $50 call for 3 7/8 (i.e. the investor has the right to put the X stock at $40 and has sold the right to call the X stock at $50). Under current law, this cost-less collar would allow the investor to continue to receive the DRD. However, under the proposed change to the holding period rules, the investor would not be entitled to the DRD. The proposed legislation would discourage this investor from entering into legitimate market-driven hedging strategies by penalizing the investor through a disallowance of all or a portion of the DRD.

Example 3: A corporate investor purchases shares of Corporation Y stock for $42 on March 15, 1996. For the purposes of obtaining an enhanced return, the investor immediately sells a June 1996 $40 call on the Y stock for 4 1/8 (a qualified covered call) to make an expected gross profit of 2 1/8 because the investor believes there is a limited risk below $40. On June 19, 1996, two days prior to the expiration of the June contract, when the stock price of the Y stock is $46, the corporate investor continues to believe that the Y stock price has limited risk below $40. Therefore, the investor "rolls" its June call position into a December call position by buying back the June 1996 call at $6 and selling December 1996 call for 8 1/4 for a net credit of 2 1/4. Under current law, all dividends received would be entitled to the DRD. Under the proposed change to the DRD holding period rules, the corporate investor would not be entitled to the DRD with respect to dividends received during the period it is hedged with the December call, subjecting dividends received by a corporate investor to three levels of taxation. Consequently, the proposed legislation would discourage corporate investors from engaging in enhanced return strategies.

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[1] Most states follow the federal income tax rules in imposing a state corporate income tax on corporations. For individual shareholders that own stock in corporations that operate in states with a high marginal tax rate, the result of this change to the DRD rules are magnified. For instance, assuming that the corporation and the corporate shareholder under the facts of the example above operate in a high state taxing jurisdiction and pay an effective federal and state tax rate of 40%, the corporate shareholder would only receive a $60 dividend and would pay $24 of tax on such dividend. The corporate shareholder would then distribute the $36 to its individual shareholders who, after paying a tax of 39.6%, would be left with only $21.74. The corporate earnings would have been subject to an effective income tax rate of 78%.

Example 4 Similar to Example 3, a corporate investor buys Z stock at $53 with a 3.5% dividend yield in January 1994. For purposes of obtaining an enhanced return, the investor sells a January 1996 $50 call on the Z stock (having an implied volatility of 22) for 8 1/2 because the investor believes there is limited price risk below $50. Prior to expiration, the Z stock is trading at $56. The investor continues to believe there is limited price risk below $50 and rolls its existing call position by buying back the January 1996 call at $8 and selling the January 1998 $50 call (which also has an implied volatility of 22) for 11 3/4, for a net credit of 3 3/4. Because of recent increased volatility in the stock market, the implied volatility of the January $50 call has increased from 22 to 30, although the Z stock is still trading in the $56 range. On a marked-to-market basis, with the price of the stock virtually unchanged, the January $50 1998 call has increased from 11 3/4 to 14 7/8. The taxpayer purchased the Z stock and wrote the calls with the expectation of receiving the DRD and an enhanced return from premium. The proposed change to the holding period rules would dramatically impact the expected return. More importantly, unwinding the position at this time would result in a projected loss of 3 1/8 per share. This example demonstrates that, if Congress were to enact the proposed change to the DRD holding period rules, it would be inequitable not to grandfather existing positions.

Corporate investors will be discouraged from entering into hedging transactions through the use of options such as those described above because of the possibility of losing the DRD. This decrease in corporate investor participation in the options markets would result in wider spreads and greater volatility in options pricing. Ultimately, this will lead to less liquidity in the options markets, including the stock market whose trading volume is greatly influenced by the trading volume of the option markets.

This change to the DRD holding period rules would also increase the cost of capital for many corporate issuers of stock, especially issuers of preferred stock. The proposed holding period changes will create uncertainty as to the availability of the DRD for many preferred stock investors. Preferred stock issuers likely will have to increase the dividend yield to compensate for this uncertainty. The increased cost of capital will have particular impact on certain industries, such as utilities, in which preferred stock comprises a significant component of the capital structure.

The current 46-day and 91-day holding period requirements and other related provisions ensure that the benefit of the DRD is available only for economic investments (as opposed to tax-motivated) in which the investor bears risk of loss for a meaningful period. First, no DRD is allowed with respect to any dividend on any share of stock which is held by the taxpayer for 45 days (90 days in the case of preferred stock) or less. In determining whether the taxpayer has held the stock for more than 45 days, the taxpayer's holding period is reduced for periods where the taxpayer's risk of loss is diminished. The regulations interpreting when the taxpayer has diminished its risk of loss are extremely broad and in essence treat the taxpayer as having diminished its risk of loss when the taxpayer enters into a broad range of hedging transactions (other than qualified covered calls). Thus, under current law, a corporate taxpayer must incur significant economic risk of loss during the 45 day holding period to be comfortable that it is entitled to the DRD.

Second, no DRD is allowed to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property. This rule is applicable to all dividend payments received by the corporate taxpayer and will prevent the taxpayer from obtaining a DRD even if the taxpayer has satisfied the holding period rules described above.

Third, no DRD is allowed to the extent that the taxpayer finances the purchase of its stock investment with indebtedness. This rule denies the DRD to a taxpayer that has satisfied with holding period rules and related payment rules described above.

The proposed modification to the DRD holding period rules will place corporate investors in the position of having to choose between entering into a bona fide hedge to reduce risk or losing the DRD. Congress should not pass legislation which either discourages hedging or increases triple taxation of corporate earnings.

Appendix A

Assumptions

1. Individual taxpayer with a combined marginal tax rate of 30% on long-term capital gains
2. 6% cost of money
3. Cost basis of $50
4. Annual cost of 100 basis points for top professionals customers; 150 basis points for typical large client
5. The benefit of the tax deferral is computed assuming: (a) a one-year deferral[2] and (b) a five-month deferral (to take account of estimated tax liability)[3]
6. The breakpoint represents the number of days that must pass before the cost of the short-against-the-box exceeds the benefit of the tax deferral

Illustrations

A. 25% Appreciation ($62.50 Fair Market Value)

	Top Professional Customer		**Typical Large Client**	
Deferral Benefit:				
one-year	.225		.225	
5-month		.094		.094
Annual Cost	.625		.938	
Breakpoint	**132 days**	**55 days**	**88 days**	**37 days**

B. 50% Appreciation ($75 Fair Market Value)

Deferral Benefit:				
one-year	.45		.45	
5-month		.188		.188
Annual Cost	.75		1.125	
Breakpoint	**219 days**	**92 days**	**146 days**	**61 days**

C. 100% Appreciation ($100 Fair Market Value)

Deferral Benefit:				
one-year	.90		.90	
5-month		.375		.375
Annual Cost	1.00		1.50	
Breakpoint	**329 days**	**137 days**	**219 days**	**92 days**

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[2] Assumes no estimated tax liability

[3] Assumes no estimated tax liability in the year of the short sale, but estimated tax payments are made in the year of sale

**COMMENTS OF
THE CHICAGO BOARD OF TRADE AND
THE CHICAGO MERCANTILE EXCHANGE
SUBMITTED TO
THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
MAY 15, 1996**

The Chicago Board of Trade ("CBOT") and the Chicago Mercantile Exchange ("CME") are submitting this statement in response to Chairman Archer's request on April 15, 1996 for comments by the public on tax provisions contained in the President's 1997 Budget proposals. Our comments are directed to the proposal to impose a constructive sale on certain "appreciated financial positions" – a proposal apparently designed in reaction to a "short-against-the-box" transaction in the stock market.

The CBOT and CME are the two largest markets in the world for transactions in futures contracts and options on futures contracts. The principal purpose of these contracts is to provide a means for the hedging of business and investment risks. The functioning of our markets can be impaired if tax rules threaten to penalize legitimate risk management activities.

The constructive sale proposal causes some concerns for our markets, even though the current tax planning strategies seemingly targeted by the proposal cannot be implemented on U.S. futures exchanges. The proposed statutory language does not appear to apply to transactions on the CME and CBOT, so long as the language is reasonably interpreted in light of the apparent purpose for the provision and its relationship to existing tax rules. However, the proposed language is so ambiguous, and the expressed purpose so ill-defined, that the proposal could have some negative effects on our markets if it is adopted in its current form.

We urge that, if it is believed desirable to address the tax results for the short-against-the-box transaction, the provision be drafted narrowly to ensure that U.S. exchange-traded futures and options on futures not be adversely affected.

<u>**Description of Proposal**</u>

Under the proposal, there is deemed to be a constructive sale of an "appreciated financial position" if the taxpayer (or a related person) enters into a position with respect to "the same or substantially identical property" that for some period "substantially eliminate[s] both risk of loss and opportunity for gain" on the appreciated financial position. For this purpose, an "appreciated financial position" is "any position with respect to any stock, debt instrument, or partnership interest if there would be gain were such position sold." A constructive sale is not deemed to occur under the proposal if the appreciated financial position is subject to the existing constructive sale treatment under the mark-to-market rules of sections 475 or 1256.

A "position" is defined to mean "an interest, including a futures or forward contract, short sale, or option." A U.S. exchange-traded futures contract (or an option on a futures contract) would generally not itself be subject to constructive sale treatment under the proposal because it would generally be marked-to-market already under existing section 1256. However, at least in theory, U.S. exchange-traded futures (or options on futures) could trigger a constructive sale of appreciated stock or an appreciated debt instrument under the proposal if the taxpayer holding such appreciated property entered into a futures contract (or an option on a futures contract) under circumstances where (i) the futures or options contract is with respect to property that is considered to be the same or substantially identical to the appreciated stock or debt obligation, and (ii) the futures or options position is considered to have the effect of substantially eliminating, for some period, both risk of loss and opportunity for gain on the appreciated stock or debt obligation.

Impact of Proposal on Futures and Options on Futures

The CBOT and CME, like other U.S. futures exchanges, offer standardized futures contracts with respect to underlying property or indices. In the case of a conventional futures contract, one contracting party (the "long" party) agrees to buy and the other contracting party (the "short" party) agrees to sell a specified quantity of underlying property at a specified price on a specified delivery date in the future. Other futures contracts, particularly with respect to indices of property prices or other market information, call for final settlement in cash to reflect price fluctuations, as opposed to actual delivery of property. The exchanges also offer trading in options with respect to futures contracts. In the case of either futures or options on futures, most contracting parties close out their positions prior to the delivery or final settlement date by engaging in an offsetting transaction on the exchange (e.g., a party with a long futures position enters into a short position having the same underlying property, quantity and delivery month).

The most actively traded contracts on the CME and CBOT are futures that relate to financial instruments. For example, the CME has cash-settled futures (and options on futures) with respect to various broad-based stock indices (e.g., the S & P 500 stock index). Both the CBOT and CME have futures (and options on futures) with respect to debt obligations, some of which call for actual delivery of a debt obligation (e.g., the CBOT's contract for Treasury bonds) and some of which call for cash settlement (e.g., the CME's Eurodollar contract). Accordingly, taxpayers using these financial futures contracts in connection with underlying stock holdings or holdings of debt obligations might potentially be affected by the constructive sale proposal.

Any such cloud of doubt should be removed. Irrespective of whether it is considered desirable to alter the current law treatment of a short-against-the-box transaction, a constructive current sale should not be imposed on a taxpayer who uses financial futures transactions to hedge the risk associated with holdings of stock or debt obligations.

A contract to sell in the futures market and a current sale in the so-called "cash" market cannot be regarded as being interchangeable versions of the same substantive transaction.

- Unlike a sale in the current (or "cash") market, a futures transaction involves no current transfer of property and no current payment for a transfer of property. Any purchase, sale and payment of sale proceeds occurs in the future. In contrast, a short-against-the-box involves a current transfer of property (borrowed by the short seller) to a purchaser, who pays currently a purchase price for the transferred shares (with the sale proceeds generally being held by the stock lender to secure the short seller's obligation to "repay" the borrowed property).

- Because futures transactions involve sales (or cash settlements) in the future, the sales price in a futures transaction is rarely the same as the sales price in the cash market. The futures price may be higher or lower than the cash price, depending upon such factors as the period of time to delivery (or final cash settlement), costs associated with holding the underlying property, and the amount of current earnings realized by a holder of the underlying property. In any event, these price differences reflect a real economic difference between a futures transaction and a transaction in the cash market, including a short-against-the-box transaction.

- Because a futures contract involves no current sale or purchase, the holder of a short futures position who also holds stock or a debt obligation has the right to any dividends or interest on the underlying securities. In contrast, a short seller-against-the-box effectively foregoes earnings on the securities he continues to own by obligating himself to make dividend or interest substitute payments to the securities lender.

- Persons who enter into short futures contracts (i.e., contracts to sell) in lieu of selling in the cash market generally do so to serve non-tax risk management objectives related to the distinct economic characteristics of futures transactions, not to postpone a gain that would be realized in a sale on the cash market.

It would be especially inappropriate to impose constructive sale treatment in the case of hedges on U.S. futures exchanges because all transactions on those exchanges involve standardized contracts traded in public markets.

- Persons who enter into countervailing positions on a futures exchange and another public marketplace (including a public cash market) perform an important economic function of minimizing inter-market pricing distortions and enhancing the future price discovery function of the futures market. As noted above, there is generally a difference between a futures price and a cash market price. Arbitrageurs place appropriate trades in the respective markets to benefit when the price spreads are too wide or too narrow, and this profit-seeking activity also benefits the marketplace by tending to bring the respective price relationships back into proper alignment.

- Because U.S. exchange-traded contracts are standardized, a financial futures contract is rarely a perfect offsetting match for a position in the underlying property. The resulting "basis risk" means that hedges using U.S. exchange-traded financial futures (or options on futures) rarely, if ever, "substantially eliminate" risk of loss and opportunity for gain.

- Most futures contracts call for delivery (or final settlement) in the relatively near future and, in any event, rarely more than two years distant. This short-term feature, coupled with the mark-to-market and straddle rules discussed below, makes U.S. exchange-traded futures (and options on futures) less susceptible than some off-exchange contracts to long-term deferral of tax on "locked-in" gain.

- Because of the liquidity of contracts traded on U.S. futures exchanges, futures positions can be readily disposed of. As a consequence, a hedge may be held for only a short period of time before being closed out through an offsetting exchange transaction. Unlike a typical short-against-the-box transaction where the taxpayer actually makes a sale (with borrowed shares) subject to an obligation subsequently to repay the borrowed shares, most holders of a short futures position never actually engage in a sale of the underlying property through the futures markets.

Most U.S. exchange-traded futures (and options on futures) are already marked to market under section 1256 and are also subject to the straddle rules of sections 1092 and 263(g).

- A taxpayer motivated solely by a desire to postpone recognition of gain on appreciated securities finds the futures markets an unaccommodating mechanism for doing so. Assume that a taxpayer with appreciated debt securities enters into short interest rate futures, and add the unlikely assumption that the appreciated securities and the short futures are so perfectly matched that risk of loss and opportunity for gain are "substantially eliminated." Under these circumstances, any subsequent market movement in the cash securities is offset by an opposite market movement in the short futures position, so that the preexisting gain might be regarded as being locked-in. But the locked-in gain is not effectively shielded from tax. If the appreciated securities subsequently lose value, the offsetting futures gain, and thus effectively a portion of the overall locked-in gain, will generally be taxed currently under the mark-to-market rules of section 1256. On the other hand, if the appreciated securities subsequently gain additional value, the resulting mark-to-market loss on the offsetting futures position cannot generally be recognized currently on account of the loss suspension rules for straddles under section 1092.

- Under section 263(g), interest and other costs of carrying a security must be capitalized, rather than deducted currently, if the security is hedged in a manner that substantially diminishes risk of loss.

- There is no need to create an additional constructive sale rule to prevent any taxpayer manipulations using futures contracts. A new constructive sale rule would only add complexity and create uncertainty for legitimate market-driven transactions.

Conclusion

We are concerned with the notion that a contract for future sale and delivery of property should be treated for tax purposes as a constructive current sale of the underlying property. Such a proposal is particularly disturbing if it has potential application to futures contracts traded on U.S. exchanges, which serve important non-tax risk management functions. A proposal inspired by purported tax manipulations through short-against-the-box transactions in the cash market for stock, should not cast any doubt on the continuation of current law tax treatment for futures transactions.

At a minimum, if the basic proposal is adopted, the legislation should make the following changes or clarifications:

- It should be made clear that stock index positions are not covered by the proposal. The regulations under section 246(c)(4)(C) and section 1092(d)(3)(B)(i)(II) provide detailed rules specifying the instances in which a taxpayer's stock portfolio sufficiently mimics a stock index so that a short position with respect to the index is regarded as being "substantially similar or related property" with respect to the stock portfolio. Under these Code provisions and regulations, the consequence of such a "substantially similar or related property" finding is application of straddle rules and, for corporate taxpayers, limitations on the dividends reduced deduction. The implication of these provisions is that a position with respect to a stock index is never considered to be a position with respect to property that is "substantially identical" to stocks in a portfolio. Cf. sections 246(c)(4)(A) and (C); sections 1092(d)(3)(B)(i)(I) and (II). If the short-against-the-box proposal is adopted, this implication should be confirmed to avoid undesirable disruption of stock portfolio hedging activities.

- If it is considered desirable to apply the proposal to debt obligations, notwithstanding the absence of evidence of tax deferral abuses with respect to such securities, the constructive sale treatment should not be applied with respect to debt obligations hedged through U.S. exchange-traded futures (or options on futures). Because of the standardization of exchange-traded contracts, it is very unlikely that such contracts should ever be regarded as "substantially eliminating" risk of loss and opportunity for gain with respect to debt obligations held by the taxpayer. Even if such a "substantial elimination" test could be met in a particular instance, the combination of the mark-to-market rules of section 1256 and the straddle rules of sections 1092 and 263(g) should be more than sufficient to prevent tax manipulations.

STATEMENT OF COALITION OF ALTERNATIVE RISK FUNDING MECHANISMS (CARFM) SUBMITTED BY JON HARKAVY, PRESIDENT

This testimony is submitted on behalf of the Coalition of Alternative Risk Funding Mechanisms (CARFM) in opposition to the Administration's recent proposal regarding captive insurance (the "Captive Proposal") contained in Title IX, Section 9562 of the March 19, 1996 Budget Bill, which we believe will disrupt a significant marketplace depended upon by commercial insurance consumers to deal with their risk management and policyholder needs.

CARFM is an organization composed of six associations representing policyholder owned (captive) insurance companies, including the Captive Insurance Company Association (CICA), the Colorado Association of Captive Entities (CACE), the Hawaii Captive Insurance Council (HCIC), the Illinois Captive and Alternative Risk Funding Insurance Association (ICARFIA), the National Risk Retention Association (NRRA), and the Vermont Captive Insurance Association (VCIA). CARFM and its member associations represent insurance consumers who have sought to reduce their insurance costs and to address cyclical insurance availability/affordability problems by forming member/policyholder owned insurance companies.

The motivation to form the type of captive insurance companies that are recognized as insurers under decided case law is generally business-driven, not tax-driven. Captives provide business options in the face of lack of adequate insurance capacity or the commercial market's inability to respond to particular needs of an industry. Often, these are new industries most important to economic development. Unavailability of coverage, consolidation of premium funds, centralized claims management, and access to worldwide reinsurance markets for excess coverage are generally recognized as reasons for forming a captive insurance company. Given this business reality, what tax policy could justify treating, for example, a mutual insurance company with 10 equal insureds as something other than an insurance arrangement for tax purposes?

By way of background, the alternative insurance market which CARFM members represent has been estimated to include over 25% of the global reinsurance market, or about $87 billion dollars annually.[1] We provide this statistic to demonstrate the magnitude of the disruption that can be caused by the Treasury's "sledgehammer" approach to dealing with an issue which, by its own revenue estimate, is small in nature.

Under the Captive Proposal, a captive would be treated as an insurance company <u>only if less than</u> 50% of the captive's net written premium is attributable to the insurance or reinsurance of risks of "related persons." For purposes of the provision, a related person would be any 10% shareholder of the captive and any person which "controls" (<u>i.e.</u>, owns more than 50%, by vote or value) or is "controlled" by the captive or is under "control" of the same person or persons that "control" the captive. If the 50% test is <u>not</u> satisfied, then the captive would not be treated as an insurance company. Premiums paid by related persons would essentially be treated as deposits, with no immediate deduction allowed by the insured and no immediate income accrued by the captive. Premiums paid by unrelated parties to the captive, however, would constitute income to the captive, but loss or unearned premium reserves would not be allowed. Moreover, the Internal Revenue Service would be allowed to consider certain unrelated parties to be related for purposes of the Captive Proposal.

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1 Rosenbaum, D. Hugh, Editor, <u>Captive Insurance Company Reports</u>, Tillinghast, a Towers Perrin Company, June 1993, pg. 1.

I. THE CAPTIVE PROPOSAL REJECTS WIDELY ACCEPTED JUDICIAL PRECEDENTS WHICH DEFINE "INSURANCE" FOR TAX PURPOSES

a) 50% Threshold for Unrelated Risks.

The Tax Court, the U.S. Court of Federal Claims and several circuit courts have addressed the effect of unrelated risks on the treatment of related party transactions as insurance for tax purposes.[2] The courts concluded that the insurance of risks of unrelated parties enhanced the risk shifting and risk distribution necessary to constitute insurance for tax purposes. Based upon expert insurance and actuarial evidence, the Tax Court and the Ninth Circuit Court of Appeals found in one case that the insurance of 30% unrelated risks was sufficient for insurance treatment.[3]

The 30% unrelated premium threshold was not arbitrarily selected by the courts. It relies upon the judgment of insurance experts that "insurance" in substance exists with such a level of unrelated premium and establishes a clear, easily applied standard for the IRS and for taxpayers.

The Captive Proposal, in contrast, is wholly arbitrary. It is not based upon any expert judgment or evidence about the nature of insurance.

b) 10% Large Shareholder Definition.

The Captive Proposal would treat as non-deductible premiums paid by 10 percent or more shareholders if insufficient business exists from smaller shareholders or others. This standard is totally arbitrary and would have a devastating effect on many group-owned captives, i.e., captives owned by groups of wholly unrelated parties. It is also directly contrary to all commonly understood definitions of insurance used by the courts or by experts in the insurance industry. For example, consider a captive owned equally by ten (10) unrelated taxpayers which pay equal premiums to the captive. The Captive Proposal would appear to treat all of the premiums received by the captive as non-deductible premiums.[4] This makes no sense at all, since from an economic perspective each unrelated insured has 90% third party business.

The 10% large shareholder rule would be detrimental especially to small businesses which often form group captives in order to pool risks that could only be insured at higher costs in the traditional market. For example, many small farm mutual and reciprocal insurance companies exist, in which small rural groups pool their resources and insure one another. To take another common example, small groups of hospitals commonly form group captives in order to pool their exposures that would be uninsurable in the commercial market. Such long-standing institutions would effectively be destroyed by the Captive Proposal. We do not understand the rationale for denying a premium deduction and insurance company status in such cases, where all would agree that from an economic standpoint risk shifting and risk distribution, the hallmarks of insurance, exist.

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[2] See, e.g., AMERCO & Subsidiaries v. Com., 96 T.C. 18 (1991), aff'd., 92-2 USTC Section 50,571 (9th Cir. 11/5/92); Sears Roebuck & Co. v. Com., 96 T.C. 61 (1991), aff'd. in para. and rev'd. in para. 92-2 USTC Para. 50,426 (7th Cir. 8/18/92); Ocean Drilling & Expl. Co. v. U.S., 24 Cl. Ct. 714 (1991), aff'd. per cur., 93-1 USTC Para. 50,160 (Fed. Cir.).

[3] The Harper Group v. Com., 96 T.C. 45 (1991), aff'd., 92-2 USTC Para. 50,572 (9th Cir. 11/5/92).

[4] The unreasonableness of the proposal is demonstrated by the fact that by arranging the ownership of the captive, one might attain insurance treatment for tax purposes: e.g., one shareholder/insured owns 49% of the stock and is responsible for 49% of the premiums, with the other nine shareholders/insureds all below 10%. Apparently, the premiums of all shareholder/insureds would qualify for insurance treatment in this example.

In sum, the "large shareholder" rule has the effect of denying insurance treatment for tax purposes where there is a true pooling of risks -- i.e., where true risk shifting and risk distribution exist in an economic sense. It is our understanding that not even the IRS questions insurance treatment in these circumstances.

II. THE CAPTIVE PROPOSAL WOULD ELIMINATE IMPORTANT MARKETS FOR THIRD PARTY BUSINESS

a) Treatment of Insurance from Small Shareholders and Non-Shareholders.

Because the Captive Proposal keys off the definition of insurance company for tax purposes, a captive that has significant unrelated business could nonetheless not be considered to be an insurance company for tax purposes. Although the insured in such case would not be denied a premium deduction, the effect on the captive would be devastating. Even though the captive is assuming risks of third parties, because it is not considered to be an insurance company, it would not be entitled to take reserve deductions and, as a result, would be taxed on the gross amount of premium income. By contrast, a commercial insurance company would only be taxed on the net profit on the contract after reserves for losses to be paid in the future are taken into account. This disparate treatment would effectively prohibit captive insurance companies from insuring any unrelated parties, unless such premium would immediately constitute more than 50% of the company's net premium. Non-insurance company treatment with respect to the unrelated business would therefore eliminate most captives from the commercial insurance market, a market in which captives have had an ever increasing share over the years, and would have an anti-competitive effect.

b) Overreaching Definition of Large Shareholder.

Especially disturbing in the Captive Proposal is the regulatory authority given to the Treasury to promulgate regulations that would treat as "large shareholders" parties that have contractual relationships with the large shareholders and who purchase insurance from the captive. The Treasury Explanation indicates clearly that this legislative authority should extend to the type of arrangements that courts and the IRS have traditionally considered to be valid third party business for purposes of qualifying the captive as a valid insurance company.

For example, the courts have approved as valid third party business insurance purchased by customers of the captive's owner. There is no reason to consider this third party business to be that of the owner, particularly since the result apparently would be that the customer would not be able to deduct the premiums paid to the captive.

Many significant insurers insure primarily the risks of persons with whom the owner has contractual relations. For example, a number of well-known manufacturers and finance companies have "captives" that insure risks of their independent dealers or their finance customers, with premiums and reserves in the hundreds of millions of dollars or more. These risks are clearly third party business with respect to the owner of the captive.

Under the Captive Proposal, however, the Treasury would have authority to consider these premiums to be related to the captive's owner, denying the premium payor a deduction and eliminating the ability of the insurance company to take reserves. Suffice it to say, these captives (which are significant insurers) would soon be out of business, if no deduction were permitted them for reserves.

Even if regulations ultimately exempt such transactions, it is likely that such regulations will take a number of years to be promulgated. In the meantime, taxpayers will have to operate under the specter of regulations that could destroy valid businesses.

III. THE CAPTIVE PROPOSAL WOULD REQUIRE AN UNNECESSARY EXCISE TAX PENALTY

Particularly objectionable is what is essentially a no-fault penalty contained with regard to the application of the Section 4371 excise tax. Under the Captive Proposal, the application of the excise tax hinges upon the mere taking of a deduction on the tax return for the premium, even if the premium deduction is ultimately not allowed. Under current law, no excise tax would apply if ultimately there is no premium deduction because the arrangement does not constitute insurance.[5] This is a logical extension of the requirement that the excise tax apply to policies of "insurance."

By contrast, the Captive Proposal would apply the excise tax even to situations where no deduction is ultimately allowed, but a deduction is taken on the return. Given that there will likely be many uncertainties in the interpretation of the statute and the regulations, this provision is merely a means of enacting a penalty on taxpayers without calling it one. Taxpayers should not be penalized for taking legitimate, good faith or reasonable interpretations of a statute or regulations.

IV. THE CAPTIVE PROPOSAL WOULD IMPOSE BURDENSOME RECORD KEEPING REQUIREMENTS

The Captive Proposal authorizes Treasury to promulgate regulations requiring shareholders of captives or related persons to maintain appropriate records and denies a premium deduction to persons who do not satisfy these record keeping requirements. This aspect of the Captive proposal apparently derives from a perceived inability of the Internal Revenue Service to obtain information concerning captive insurance companies. We believe that the Internal Revenue Service is significantly overstating the problem. In our experience, the Internal Revenue Service has not had problems receiving information from offshore captive insurance companies with respect to their income. Moreover, to the extent there are problems with receiving such information, the Internal Revenue Code contains summons provisions that effectively penalize a shareholder or insured who fails to provide the requested information. We do not disagree that the Internal Revenue Service should have the ability to require taxpayers to justify their deductions. However, we are concerned that the Treasury will use this power as an opportunity to require all shareholders, no matter how small, to provide full financial and ownership information with regard to the captive insurance company. Many times this will be impractical. If such record keeping is required, it should be limited to large shareholders of the captive and related parties.

V. THE CAPTIVE TAX PROPOSAL WILL GENERATE SIGNIFICANT UNFUNDED TAX LIABILITIES THAT MAY THREATEN CAPTIVE INSURER SOLVENCY

a) Application of the General Provisions of the Code to Insurers Not Meeting the 50% Test.

Under the Captive proposal, if the 50% test is not satisfied, the captive is no longer considered an insurance company. As a result, any premiums paid by unrelated parties to the captive would not be entitled to insurance accounting treatment. In the absence of such treatment, the premiums would constitute current income and the captive would not be able to take unearned premium reserves and loss reserves to reflect the very real liabilities to which it is subject. Thus the Captive Proposal would create huge unfunded tax liabilities for a number of single owned captives, group captives and pools, which would realistically render a number of them insolvent, thereby jeopardizing policyholders, claimants, and potentially a number of state insolvency funds.

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[5] See Rev. Rul. 78-277, 1978-2 C.B. 268.

Only a small portion of the premium which an insurance company collects is taxed as current income, for the simple reason that the most significant portion of the premium is set aside in loss reserves to pay claims, and other significant percentages of the premium dollar are needed to cover operating expenses. Indeed, the major concern of insurance regulation is protecting policyholders and claimants by making sure an insurance company has adequate loss reserves to pay claims. The Captive Proposal undermines these solvency concerns by treating all premium dollars paid by less than 10% shareholders to an insurer not meeting the proposed outside business test as current income. Consider the inequity if the Treasury decided to tax any business on gross earnings rather than on net profit. Then put this proposal in the context of an insurance company where the significant shortfall in operating revenue may very well mean that claimants and policyholders will not be indemnified for their losses.

VI. THE CAPTIVE PROPOSAL UNDERMINES THE FEDERAL LIABILITY RISK RETENTION ACT

In 1981, Congress enacted the Product Liability Risk Retention Act to encourage the formation of risk retention groups and purchasing groups to provide product liability insurance. In response to the crisis in the availability and affordability of commercial liability insurance, Congress passed the Risk Retention Amendments of 1986, which expanded on the earlier Act by permitting these groups to provide not only product liability insurance but all types of liability insurance. The stated purpose of these provisions was to allow a group of businesses to join together to set up their own insurance company to issue policies only to themselves. From a formation perspective, very few risk retention groups (RRG's) are fortunate enough during the start-up phase to have a large number of policyholders with equal access to the capital needed to form the insurance company. Generally, RRG's start forming with a comparatively small number of policyholders having concentrated ownership in the facility which is diffused after more policyholders join the group in the years following start-up. Faced with the draconian treatment afforded by the Captive Proposal, many nascent RRG's will not be able to be formed. Other RRG's in their infancy stage which do not meet the Treasury's 50% test will be faced with significant unfunded tax liabilities and real solvency concerns.

VII. THE CAPTIVE PROPOSAL OFFERS NO SIGNIFICANT REVENUE ENHANCEMENT

Indeed, the Joint Committee on Taxation estimates a $23 million revenue loss over ten years as a result of implementation of the Captive Proposal. The Administration's projections show an increase in revenue over 7 years of only $100 million. The Administration's projections under the prior proposal, which was not materially different from the current proposal, showed even less revenue, with a net increase in revenues for the first seven years of $62 million, and a net decrease in revenues for years 8 to 10 of $18 million. The miniscule revenue gain does not justify the disruption to the industry and the insureds who rely on the captive insurance market, nor does it justify several pages of complicated statutory language which contemplates the issuance of more pages of complicated regulations.

In conclusion, the Captive Proposal is completely without merit. It replaces existing standards of insurance principles and a body of judicial decisions justifiably relied upon by taxpayers with completely arbitrary standards that will impose upon both the Treasury and taxpayers horrendous regulatory compliance difficulties and will subject certain captives and small insurers to unfunded, unforeseen tax liabilities which could threaten their very solvency. In doing so, the Treasury will be disrupting a significant alternative insurance marketplace depended upon by commercial insurance consumers to meet risk management needs not addressed by the cyclical traditional insurance industry. Indeed, the Captive Proposal would undercut the very self-help mechanism established by the federal Liability Risk Retention Act Amendments of 1986 which Congress had enacted for commercial insurance consumers. Furthermore, the Captive Proposal embodies unsound tax policy, as it would penalize those taxpayers seeking to reduce their insurance costs by utilizing more efficient means to obtain improved coverage at a lower premium. The Treasury cannot credibly argue that these legitimate economic interest should be sacrificed on the altar of revenue enhancement, for according to unbiased Joint Committee on Taxation estimates, the Captive Proposal is a revenue loser. We urge the Committee to reject the Captive Proposal as an unworkable, economically dysfunctional solution to issues which the courts and lawmakers have adequately addressed in a manner relied upon by taxpayers.

STATEMENT OF THE COALITION ON CREDIT CARD INTEREST IN RESPONSE TO THE HOUSE COMMITTEE ON WAYS AND MEANS REQUEST FOR COMMENTS ON NEW REVENUE PROVISIONS IN THE PRESIDENT'S FISCAL YEAR 1997 BUDGET

This statement is respectfully submitted on behalf of the Coalition on Credit Card Interest in response to the Committee's request for comments on revenue provisions that were included in President Clinton's fiscal year 1997 budget but not in the Balanced Budget Act of 1995. The Coalition appreciates the Committee's interest in public comments on the Administration's new revenue proposals and welcomes the opportunity to express its strong opposition to one of these proposals in particular -- the proposal to require a prepayment assumption in computing the accrual of grace period interest on credit card receivables outstanding at the end of a taxable year. The proposal is detrimental to credit card businesses located throughout the United States, including the credit card operations of commercial banking and thrift institutions, non-bank financial institutions and retailers.

BACKGROUND

Credit card issuers frequently provide an interest-free "grace period" before customers are liable for any interest charges on purchases. In a typical arrangement, interest is not charged on a customer's credit card balance (other than the portion of the balance reflecting the principal amount of cash advances) during the grace period. The grace period typically begins on the date a customer's purchase is posted to his or her account and ends a specified number of days after close of the monthly billing cycle during which the purchase is posted.

For example, assume a customer purchases goods on November 15 using a credit card with a billing cycle ending the 12th of each month and a 25-day grace period. The purchase would likely be posted to the customer's account on November 15 or 16 and would be included on the customer's bill dated December 12. Under this arrangement, the customer would not incur a finance charge on the November 15 purchase if the December 12 balance, which includes the November 15 purchase, is paid on or before January 6. If, on the other hand, the customer fails to pay the balance by January 6, interest will generally be computed based on the average outstanding balance which was increased on the date the purchase was posted to the customer's account.

Under present law, a credit card issuer is not required to include grace period interest in taxable income until the grace period has expired. As the Committee knows, a provision in President Clinton's fiscal year 1997 budget would require a "reasonable payment assumption" for interest accruals on certain debt instruments.[1] These debt instruments would include pools of credit card receivables. The proposal would require credit card issuers to use an assumption about payment patterns to accrue interest income when the receivables are outstanding over the end of a taxable year. Simply stated, the proposal would require credit card issuers to accrue an estimate of the total amount of interest income expected to be earned at the end of the grace period. This estimate would be based on the credit card issuer's assumptions of the likelihood that its credit card customers will not pay their entire balance before the end of the applicable grace period.

The Administration is proposing that this provision be effective for taxable years beginning after the date of enactment.

PROBLEMS WITH THE ADMINISTRATION'S PROPOSAL

As discussed below, the Coalition believes that the Administration's proposal is an inappropriate departure from historic tax accrual standards. Additionally, the Coalition believes that this proposal is not a "loophole" closer as the accrual method of accounting can hardly be viewed as a tax "loophole" or contributing to "corporate welfare." On the contrary,

[1] See, Department of the Treasury, General Explanation of the Administration's Revenue Proposals, March 1996, at pages 76-77.

adopting the proposal in question can only be viewed as a tax increase on credit card issuers and an arbitrary departure from well-established tax policy. The Coalition strongly urges the Committee not to adopt the Administration's proposal in any form at any time.

1. **The Proposal is an inappropriate departure from Tax Accrual Standards**

Accrual method taxpayers are generally governed by the "all events test" which dates back to the 1926 Supreme Court case of United States v. Anderson.[2] In deciding the appropriate time for an accrual method taxpayer to accrue a deduction for a munitions tax liability, the Court stated: "in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it."[3] The all events test subsequently became the consistent standard for accruing both income and expenses. The Treasury Regulations provide:

> Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.[4]

The importance of accruing income and expense items based on a consistent standard cannot be overstated. In order to prevent a distortion of taxable income, the use of estimates should not be required for accruing income if estimates are not permitted in accruing expenses. As you are aware, estimates are not permitted in accruing expenses. For example, taxpayers are not permitted to accrue an estimate of the liability for self-insured medical costs even though the amount of the liability to be incurred can be accurately predicted by the taxpayer.[5] In addition, all other types of reserves, including bad debt reserves, are not permitted as a deduction against taxable income.

As stated above, the right to receive credit card interest does not become fixed, and therefore is not includible in taxable income, until the end of the grace period. While the extent to which a credit card customer will pay the outstanding balance before the end of the grace period could be estimated, predictions of uncertain future events have long been rejected as a basis for tax accounting on both the income and the expense side. A return to the use of estimates solely on the income side represents a one-sided departure from long established accrual principals and will significantly distort taxable income solely for the sake of a one time revenue raiser.

2. **The Administration Erroneously Equates Stated Interest on Credit Card Receivables with Original Issue Discount on REMIC Regular Interests and Qualified Mortgages.**

The Treasury Department's General Explanation of the Administration's Revenue Proposals suggests that the rationale for this proposed change is to treat interest on credit card receivables in a manner similar to the current law treatment of real estate mortgage conduit (REMIC) regular interests and REMIC qualified mortgages. Treasury's explanation, however, fails to state that the prepayment catch-up method applied under current law to REMIC regular interests and REMIC qualified mortgages is used solely to amortize fixed amounts of original issue discount, market discount or bond premium. Thus, under current law, the prepayment catch up method merely effects the timing of the recognition of a fixed amount of income.

The prepayment catch-up method is not applied to the accrual of qualified stated interest. As a result, qualified stated interests on both REMIC regular interests and REMIC qualified mortgages is accrued under the all-events test of Internal Revenue Code section 451. Moreover, the prepayment catch up method is not applied under present law to accrue any amount of income that is not fixed.

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[2] 269 US 422 (1926).
[3] 269 US at 441 (1926),
[4] Treas. Reg. §1.446-1(c)(1)(ii). See also Treas. Reg. §§1.451-1(a) and 1.461-1(a)(2)(i).
[5] United States v. General Dynamics Corp., 481 US 239 (1987).

Therefore, the fact that the prepayment catch up method applies under current law to REMIC regular interests and REMIC qualified mortgages does not provide any justification as a matter of tax policy for applying prepayment assumptions to the accrual of grace period interest on credit card receivables. As stated above, grace period interest is not fixed until the end of the grace period. In addition, once it becomes fixed, it is qualified stated interest rather than an amount of discount or premium. Unlike with REMICs, applying prepayment assumptions to grace period interest effectively results in a tax on income that has not been, and may never be, earned.

RECOMMENDATIONS

For the reasons set forth above, the Coalition strongly urges the Committee not to include the Administration's proposal to require the use of estimates for interest accruals on credit cards providing for a grace period, this year or in the future. The Coalition recognizes the need for modernization in the financial products area but believes this provision inappropriately attempts to treat contingent interest in the same manner as a fixed amount of original issue discount. Effectively, this proposal represents a tax increase on credit card issuers, not the closing of a corporate loophole.

The Coalition appreciates the Committee's interest in its views on this significant issue.

TESTIMONY OF

COOPERS & LYBRAND L.L.P.
AND
THE SECTION 1374 COALITION

REGARDING ADMINISTRATION'S PROPOSAL TO REPEAL IRC SECTION 1374

BEFORE

THE HOUSE WAYS AND MEANS COMMITTEE

MAY 15, 1996

[written testimony submitted for the record]

Mr. Chairman and members of the Committee:

Coopers & Lybrand and the Section 1374 Coalition are pleased to have the opportunity to comment on the Administration's proposal to impose a liquidation tax on C Corporations converting to S Corporation status. The proposal was included in President Clinton's Fiscal Year 1997 budget submission to Congress on March 19, 1996. We commend Chairman Archer and the Committee for its leadership in examining this issue, and we appreciate the opportunity to comment on behalf of the Firm and certain clients.

Coopers & Lybrand and the Section 1374 Coalition strongly oppose the proposal included in the President's FY 1997 budget submission. It is our belief that the proposed liquidation tax would constitute a significant change in corporate tax law, contradicts sound tax policy and would inappropriately deter, if not eliminate, future C corporation conversions to S corporation status. This proposal represents a drastic change to current law and has not been the subject of Congressional hearings. Additionally, the primary purpose behind Treasury's proposal, which is not coupled with other S corporation reform and simplification proposals, is to raise revenue in a manner we find short-sighted and inappropriate as a tax increase measure.

We would also point out that this proposal is a departure from the Administration's prior position as stated by Treasury Assistant Secretary for Tax Policy Leslie Samuels who testified that significant changes to Subchapter S should only be made "pursuant to a comprehensive, deliberate process, rather than on a piecemeal basis."[1] Coopers & Lybrand and the Coalition support S corporation simplification provisions included in the *S Corporation Reform Act of 1995*, introduced in the House and Senate (H.R. 2039 and S. 758). We also support the S

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1 Testimony of Assistant Secretary Samuels on Miscellaneous Revenue Issues, before the House Ways and Means Subcommittee on Select Revenue Measures, Serial 103-63, Part 1, pg. 311, June 22, 1993).

corporation provisions included in H.R. 2491, the vetoed *Balanced Budget Act of 1995*, but are disappointed that several meritorious changes were dropped without adequate debate from the final version of H.R. 2491.

BACKGROUND

S corporations have been a long-standing, recognized tax entity. In 1958, Congress enacted Subchapter S of the Internal Revenue Code to permit owners of businesses which had incorporated an entity for business and legal purposes to elect to be treated for tax purposes in a manner similar to a partnership. By nature S Corporations are hybrid entities including some features similar to flow-through entities while others follow the corporate model.

Congress modified the S corporation rules in 1982, focusing on simplification and removing traps for the unwary. This tax act reaffirmed S corporations as an acceptable form of tax entity and recognized a long-accepted policy to integrate the corporate and individual tax systems for closely-held businesses. During Congressional deliberations of the 1982 act, a liquidation tax similar to the Administration's proposal was considered and rejected. Instead, Congress implemented a tax on excess passive income for S corporations that were previously C corporations, allaying concerns that personal holding companies could avoid their penalty tax by electing S status. A liquidation tax was not perceived necessary to curtail C-to-S conversions. In fact, a significant purpose of the 1982 act was to encourage more conversions.

Section 1374 was enacted as part of the Tax Reform Act of 1986, and was adopted primarily to prevent a C corporation from avoiding the repeal of the *General Utilities* doctrine (also enacted as part of TRA '86) by converting to S corporation status prior to a sale of its business. Hence, Section 1374 provides for a corporate-level tax on any built-in gain when assets owned as a C corporation are sold by an S corporation at anytime during the 10 years after conversion. During deliberations of the TRA'86, a liquidation tax again was considered and rejected. A determination was made then that a 10-year period provided an adequate period for collection of any tax on C corporation gains. Since enactment, it is our understanding that Section 1374 has been effective in achieving its purpose and should not be replaced with a burdensome and ultimately unfair liquidation tax.

In 1990, the House Ways and Means Committee looked again at a liquidation tax as a means of simplifying subchapter S.[2] This so-called simplification proposal was rejected and did not advance through the legislative process.

We believe it is important to note that on at least three previous occasions, Congress considered and rejected a liquidation tax comparable to the one proposed by the Administration. Unfortunately, the proposal has once again been resurrected and is now before the 104th Congress. We strongly urge you to reject this proposal because of its detrimental effect on choice of entity for small businesses.

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[2] Written Proposals on Tax Simplification, WMCP 101-27, pg. 24, May 25, 1990 (reprint of letter to Chairman Dan Rostenkowski from Ronald A Pearlman, Chief of Staff).

PRESIDENT'S PROPOSAL

The proposal from the *President's Fiscal Year 1997 Budget* submission to Congress on March 19, 1996, would repeal IRC Section 1374, thus imposing a liquidation tax on C Corporations with a value of $5 million or more that convert to S Corporation status. Currently, Section 1374 imposes a tax on built-in gains in assets held by the C corporation at the time of conversion if and when built-in gain property is disposed of during the ten-year period following the conversion. Under the proposal, a C-to-S corporation conversion would be treated as a liquidation of the C corporation followed by a contribution of the assets to an S corporation by the recipient shareholders, thus triggering an immediate recognition of gain by both the corporation and its shareholders upon the conversion to S corporation status.

The Treasury proposal would apply to Subchapter S elections that are first effective after January 1, 1997. This effective date reflects transition relief announced by Treasury earlier this year.[3] However, this transition relief in no way alleviates the burden of the liquidation tax for those existing corporations, as yet unidentified, that might want to make an S election in the future.

Although a liquidation tax has been debated on several occasions since Subchapter S was first incorporated into the Internal Revenue Code, the most recent effort to impose a tax on C-to-S conversions was proposed in a letter from Treasury Assistant Secretary for Tax Policy Leslie Samuels to Congressional leaders last July.[4] In the letter, Assistant Secretary Samuels suggested a conversion tax as a possible S corporation reform measure, stating "we should consider whether it is advisable to conform the tax treatment of the conversion of existing C corporations to S corporations with the treatment of their conversion to a partnership."

The liquidation tax proposal resurfaced again late last year as a revenue raiser offered by Treasury to offset the revenue loss associated with the *President's Seven-Year Balanced Budget Proposal*, released December 7, 1995.[5] As balanced budget talks continued between Congressional Republicans and the Administration, the proposed tax was also included in the *President's Balanced Budget Plan* submitted to Congress on January 6, 1996.[6] The latest proposal to repeal Section 1374 was included in the President's FY 1997 budget submission in March, 1996.

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[3] Treasury Announces Additional Transitional Relief, Department of the Treasury, press release, February 22, 1996.

[4] Letter from Treasury Assistant Secretary for Tax Policy Leslie Samuels to Congressional Leaders, July 25, 1995.

[5] Description of the Tax and Health Insurance Reform Provisions in the President's Seven-Year Balanced Budget Proposal Released on December 7, 1995, JCX-58-95, pg. 71, December 15, 1995.

[6] Description of Tax Provisions Included in a Plan to Achieve a Balanced Budget Submitted to the Congress by the President on January 6, 1996, JCX-1-96, pg. 35, January 24, 1996.

ADVERSELY AFFECTS C CORPORATIONS AND EXISTING S CORPORATIONS

A Liquidation Tax Would Not Result In Parity: According to the Treasury Department's *General Explanations of the Administration's Revenue Proposals,*[*] the rationale behind this provision is to treat the conversion of a C corporation to an S corporation the same as a C corporation conversion to a partnership. The proponents of this argument have indicated that imposing a liquidation tax would result in parity between S corporations and partnerships or limited liability companies (LLCs). S corporations, however, do not enjoy many of the benefits available to LLCs, and even if this proposal were enacted, the S corporation still would not be on the same level playing field as LLCs.

S corporations are formed to be a simplistic organization, taxed as a flow through entity. Owners of S corporations, in exchange for the such tax treatment, accept significant restrictions to which other tax entities are not subject. Unlike LLCs, S corporations currently have a limited number shareholders (35), none of whom can be either partnerships, other corporations or non-resident aliens. Additionally, tax-exempt organizations and certain trusts are not eligible to be S corporation shareholders and S corporations may not issue preferred stock or own more than 80 percent of another corporation's stock. Even if the S corporation reform and simplification provisions included in the vetoed *Balanced Budget Act of 1995* and other legislation currently pending before Congress (H.R. 2039, S. 758) were enacted, S corporations would still not be on equal footing with LLCs or partnerships.

Presently, there are few C corporations converting to partnership status. A liquidation tax will do little to achieve "parity" between entities, but instead will only aggravate the competitive disadvantage of businesses in C corporation form when compared to flow-through entities.

C Corporations Will Be At A Permanent Competitive Disadvantage: The Administration's liquidation tax will leave many small businesses at a competitive disadvantage with partnerships and those that have already converted to Subchapter S status. Under a liquidation tax, C corporations will be allowed to convert to S status only if they have their cash resources drained to pay the liquidation tax without first having disposed of assets. The other alternative is to continue their C status and pay the double layer of federal income tax which is what invariably all will do.

Future Subchapter S Elections Will Effectively Be Repealed: Subchapter S is a long-standing filling status permitted by current federal tax law. The tax proposed by the Administration will make almost all future elections prohibitively expensive. It runs counter to the very positive bi-partisan Congressional Subchapter S reform effort that has been co-sponsored by 22 Members of the House Ways and Means Committee and 7 Members of the Senate Finance Committee. Reforming Subchapter S is exactly what should be done and makes far greater sense than imposing a draconian liquidation tax on C-to-S conversions.

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[*] General Explanations of the Administration's Revenue Proposals, Department of the Treasury, pg. 84, March 1996.

Imposes Tax Before Assets Are Disposed: At the heart of our tax system is an established concept fundamental to assessing tax. This "wherewithal-to-pay" concept holds that income taxes should not be imposed until a transaction occurs in which the taxpayer recognizes income and has the ability to pay. Income from services or the sale of an asset result in the taxpayer holding monetary value, having the wherewithal to pay a tax on the income recognized. It is not in the best interest of U.S. commerce to impose a huge tax on the fictional liquidation proposed by the Administration on a C-to-S conversion before any assets have been disposed.

A built-in gains tax on appreciation in business assets is already imposed under current law, but only when assets are sold. The Administration's proposal would tax gains on a companies assets while still using them in an active trade or business. To pay this tax would greatly diminish business resources at a time when companies may not have the ability to pay. Thus, the proposal penalizes C corporations electing S status by requiring the recognition of gain which has not yet been realized.

Limits Ability Of Current S Corporation Growth Through Acquisition: This liquidation tax would impact all current S corporations. An S corporation that desired to grow through a corporate merger transaction with a C corporation would be subject to tax as if the acquired C corporation were liquidated. Such transactions would have prohibitive results, and current S corporations would not have the flexibility that they are now afforded. Additionally, they would be on unequal footing with C corporation counterparts in restructuring and reorganizing transactions. This effect runs counter to the many provisions in the Code that encourage growth and provide tax deferred methods to achieve it.

Undermines Integration Of Federal Income Tax System: The proposal greatly diminishes the ability to mitigate the double tax burden on C corporations' cost of capital. C corporations are burdened with two levels of federal income taxes (once at the corporate level and then again at the shareholder level). S corporations, like partnerships, pay a single level of tax at the ownership level. A tax on the appreciation in business assets at the time of the company's conversion to S corporation status would run directly counter to the effort to integrate the corporate and individual tax systems. Since taxpayers currently doing business as C corporations will effectively be denied the ability to operate under the simplicity of Subchapter S, the proposal only perpetuates the existing two-tier corporate tax system. Thus, it has the perverse effect of locking closely-held C corporations into the double-tax regime.

Corporate integration is a goal that has historically been supported by the Treasury Department. A comprehensive study released by Treasury at the conclusion of President's Ford's Administration in 1977 outlined several methods to achieve corporate integration.[8] In the Treasury report to President Reagan in 1984, Treasury asserted that "the double taxation of dividends increases the cost of capital to corporations and reduces the return to individual investors."[9]

[8] Blueprints for Basic Tax Reform, Department of the Treasury, 1977.

[9] Tax Reform for Fairness, Simplicity and Economic Growth, Volume I, Department of the Treasury, pg. 118, November 1984.

In 1992, the Treasury Department released the report *Integration of the Individual and Corporate Tax Systems*, which noted that "the current two-tier system of corporate taxation discourages the use of a corporate form even when incorporation would provide non-tax benefits such as limited liability for the owners."[10] The report further stated that "*the potential economic gains from integration are substantial.*"[11] (emphasis added).

$5 Million Threshold Complexity: The $5 million fair market value threshold for determining the applicability of the tax is not only too low a threshold to distinguish between large S corporations and small ones, but would result in a cliff. For example, if a C corporation is valued at $5,100,000, an election would result in a tax as if the company had liquidated. This would put unrealistic pressure on the difficult task of valuing the stock of a closely-held corporation. Additionally, even after obtaining an appraisal, the company could not be confident that the Internal Revenue Service would not challenge the appraisal later. Therefore, the proposal will needlessly increase controversies between taxpayers and the IRS over the value of small closely-held businesses.

S corporations of identical sizes but with different ratios of debt to equity will be treated differently. An S corporation with $10 million in assets and $6 million in debt will be able to make an S election. However, an S corporation with $10 million in assets and no debt will not be able to make an S election without a liquidation tax.

Technically Flawed: We concur with other commentators that the Administration's proposal is technically flawed for several reasons. It lacks clarity of scope, requiring taxpayers to speculate on the meaning of several aspects. Its proposed effective date has already put otherwise eligible corporations at a disadvantage to their industry competitors. It is inconsistent with subchapter S provisions allowing S corporations to be treated as regular corporations for many purposes of the Code. Additionally it's a trap for the unwary taxpayer. However, we do not recommend attempts to correct the proposal's technical deficiencies. The liquidation tax must be rejected outright.

CONCLUSION

Coopers & Lybrand and the Section 1374 Coalition urge the Committee to reject the Administration's proposal. Imposing a liquidation tax on C corporations converting to S corporation status is not only counterproductive and burdensome, but will effectively eliminate future Subchapter S.

As supporters of the S corporation reform legislation introduced during the 104th Congress, we find this proposal to be shortsighted, detrimental to business activities, and only serving to perpetuate a two-tier tax system that distorts the cost of capital. Rather than advance our tax policy towards an integrated tax system, it moves in the opposite direction. Additionally, it represents a drastic change to current law and has not been the subject of Congressional review or hearings.

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10 Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once, report of the Department of the Treasury, pg. 1, January 1992.

11 Ibid.

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EDISON ELECTRIC INSTITUTE

David K. Owens
Senior Vice President
Finance, Regulation, and
Power Supply Policy

May 15, 1996

Mr. Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Sir:

RE: Corporate Tax Reform Provision in the President's
Fiscal Year 1997 Budget Proposal

This letter is submitted in response to the request by the Committee on Ways and Means for public comments on certain revenue provisions in President's Clinton's Fiscal Year 1997 budget.

Edison Electric Institute (EEI) is the association of the United States investor-owned electric utilities and industry affiliates worldwide. Its U.S. members serve 99 percent of all customers served by the investor-owned segment of the industry. They generate approximately 79 percent of all the electricity generated by electric utilities in the country and service 76 percent of all utility customers in the nation.

EEI appreciates the opportunity to comment on two of the corporate tax reform provisions in the President's Fiscal Year 1997 Budget proposal. We are submitting an original and six copies of our comments for your consideration.

Dividends-Received Deduction

The President's plan would raise $2.9 billion over seven years by reducing to 50 percent the dividends-received deduction for corporations owning less than 20 percent of the stock of a U.S. corporation. The rationale behind this is that Treasury believes that the 70 percent dividends-received deduction is too generous for corporations that cannot be considered an alter ego of the distributing corporation because they do not have a sufficient ownership interest in that corporation. The proposal would be effective for dividends paid after January 31, 1996.

We strongly believe that the impact of this provision in the President's proposal is fundamentally anti-investment and anti-business, and will diminish capital formation, economic growth, and job creation. Under the regime of corporate taxation, the current 70 percent dividends-received deduction attempts to mitigate the middle level of taxation. Corporate income is taxed once as it is earned by a corporation, a portion of that same income is then taxed a second time when it is distributed to a corporate shareholder as a dividend; it is then taxed a third time when the recipient corporation distributes its earnings to its individual shareholders. Thus, excluding the effects of state income taxes this income is effectively taxed at a rate up to 68 percent! This is significant considering the electric utility industry pays in excess of $16 billion of dividends comprising approximately 80 percent of its net after tax savings. The revenue generated by the proposed reduction in dividends-received deduction would therefore be accomplished at the expense of exacerbating the current problem of multiple taxation of corporate income by reducing the intercorporate dividends-received deduction.

Studies by the U.S. Department of Treasury, the American Law Institute, the American Institute of Certified Public Accounts and economists from the academic have demonstrated that the multiple tax on corporate earnings results in a number of serious economic distortions that have a negative influence on the national economy. An additional tax on corporate dividends will negatively affect capital accumulation and savings, increase debt financing, reduce equity financing and by increasing the incremental cost of capital will reduce investment. Therefore, we believe that reducing the dividends-received deduction is counterproductive. As economic growth and jobs suffer, the federal revenues will decrease rather than increase.

In general, we are aware of no policy justification (other than the Administration's view that the current deduction is too high) for increasing multiple level corporate taxation and we therefore strongly oppose a reduction of the dividends-received deduction.

Elimination of the De Minimis Rule for Corporate Investments in Tax Exempt Bonds

The President's plan would also raise $0.5 billion over seven years by repealing the 2% de minimis rule for corporate investments in tax exempt bonds. This provision would create a significant, adverse impact on electric utilities' non-qualified decommissioning trust funds, which invest in tax exempt bonds to meet future obligations to decommission nuclear plants and significantly increase the cost of borrowing for state and local governments.

In order to continue to operate nuclear plants, utilities are required to provide financial assurance of the ability to fund future decommissioning costs. Most utilities are providing this financial assurance by funding decommissioning trusts. Generally, utilities are utilizing both qualified and non-qualified decommissioning trusts because full funding for qualified trusts is prohibited if the nuclear plant was in service prior to 1984. Therefore, most utilities utilize non-qualified decommissioning trusts to fund a portion of the future decommissioning obligation. The non-qualified decommissioning trusts are not obtained by borrowing, but are generally amounts specifically approved by the public service commissions to be deposited in the decommissioning trusts. Thus, the repeal of the de minimis rule would unfairly and inappropriately presume for tax purposes that approximately 40% - 50% of the cost of the tax exempt investments are funded by the debt of the utility. In addition, it would effectively reduce the earnings of these trusts, which would require the utilities' customers to pay additional amounts for future decommissioning costs.

EEI strongly agrees with the March 6, 1996 letter sent to Secretary Rubin by 35 senators explaining the adverse impact that this proposal will have on state and local governments. Rather than reiterate these concerns, EEI agrees that this proposal will adversely impact the state and local governments as many corporations, including non-qualified nuclear decommissioning trust funds of electric utilities would no longer invest in these bonds.

If you have any questions, please contact Walter W. Foyt, Chairman of the Taxation Committee of the Edison Electric Institute at 713/207-3020.

Sincerely,

David K. Owens

David K. Owens

DKO:jei

STATEMENT OF KEITH E. ENGEL
BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

I. Introduction

I am submitting this statement in opposition to section 9522 contained in President Clinton's Fiscal Year 1997 Budget Bill (the "Budget Bill"). Section 9522 creates gain recognition for certain distributions under section 355 of the Internal Revenue Code.

My interest in section 9522 of the Budget Bill is purely academic. I am currently a tax professor at Washington & Lee. My familiarity with section 355 stems from prior practice, having worked for the Office of Assistant Chief Counsel (Corporate) of the Internal Revenue Service and for the tax team at a major D.C. law firm. I was extensively involved in various section 355 issues while serving in both capacities.

For the reasons discussed below, I believe the statutory language of section 9522 of the Budget Bill does not comport with its purported policy and, therefore, Congress should substantially revise this provision's statutory language. As a result of this inconsistency, section 9522 appears to create corporate level tax for certain section 355 distributions which involve no tax avoidance concerns, and it appears to disregard certain section 355 distributions which present these tax avoidance concerns.

II. General Utilities Repeal and Section 355

As a general rule, the Internal Revenue Code imposes two levels of tax on corporate earnings generated from the sale or disposition of corporate assets. The Code imposes the first level of tax on a corporation when it sells assets, and the Code imposes a second level of tax on the corporation's shareholders when the corporation distributes net gain proceeds.

Prior to 1986, the Code contained numerous exceptions to this dual level of tax, commonly known as the General Utilities rule. See generally General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935). As commonly used, the General Utilities rule refers to any exception from corporate level tax when a corporation disposes of appreciated assets. In 1986, Congress repealed the General Utilities rule, attempting to ensure the dual level of tax on corporate earnings was fully preserved . The centerpiece of General Utilities repeal was the consistent imposition of corporate level tax when a corporation distributes appreciated assets to its shareholders via a liquidating or non-liquidating distribution.

One exception to General Utilities repeal is section 355. In a section 355 distribution, a parent corporation ("Distributing") can distribute the stock of a controlled subsidiary ("Controlled) without tax at both the corporate and shareholder levels. Congress preserved tax-free treatment for section 355 distributions despite overall General Utilities repeal because a section 355 distribution "merely effects a readjustment of the shareholder's continuing interest in the corporation in modified form." Staff of J. Comm. on Tax'n, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, 337 (May 4, 1987).

In 1990, Congress enacted section 355(d) of the Internal Revenue Code, which imposes a corporate level tax on certain section 355 distributions. The purpose of section 355(d) is to prevent taxpayers from using section 355 as a mechanism to dispose of controlled subsidiaries "in transactions that resemble sales, or to obtain a fair market value stepped-up basis for any future dispositions." H.R. Rep. No. 101-37, 101st Cong., 2d Sess. 70-71 (Oct. 15, 1990).

For example, assume Distributing owns all of Controlled, and Distributing plans to sell Controlled to Acquiring for cash. If Distributing simply sells Controlled for cash, Distributing would recognize gain on the Controlled stock. On the other hand, prior to 1990, Distributing could arguably use section 355 as a mechanism to sell Controlled without tax. Pursuant to this plan, Acquiring would use its cash to acquire newly issued Distributing stock from

Distributing, with the Distributing stock acquired being equal in value to Controlled. After waiting some period of time (usually two years) to avoid continuity of interest concerns, Distributing would distribute the Controlled stock to Acquiring in a split off exchange for all of Acquiring's recently purchased Distributing stock. Upon completion, Distributing effectively receives cash in a tax-free exchange for all of the Controlled stock by virtue of section 355. Thus, through the use of this overall section 355 mechanism, Distributing achieved the same economic effect of a straight sale but avoided the corporate level tax. See Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), aff'd per curiam, 886 F.2d 1318 (7th Cir. 1989) (involving a pre-1986 version of a section 302/311 distribution using a similar method to accomplish a tax-free disposition).

Section 355(d) ends the above tax scheme by creating corporate level gain if a shareholder owns a 50 percent or greater interest in either the distributing or controlled corporations after a section 355 distribution by virtue of a purchase within the 5-year period before the distribution. Thus, section 355(d) applies to the above example, requiring Distributing to recognize gain on the Controlled stock because Acquiring holds its post-split off interest in Controlled by virtue of Acquiring's purchase of Distributing stock only two years before the section 355 distribution.

III. General Description of the Proposal

Section 9522 of the Budget Bill extends section 355(d) corporate gain recognition to certain section 355 distributions that do not satisfy the following shareholder-control requirement. Under this shareholder-control requirement, the direct and indirect pre-distribution shareholders of the distributing corporation must, as a group, control both the distributing and controlled corporations after the distribution. These shareholders satisfy this control requirement only if they possess at least 50 percent of the combined voting power and total stock value in both the distributing and controlled corporations. In addition, these shareholders must maintain this control for a four year period beginning two years before the section 355 distribution. Section 9522 contains an exception to this control rule, which allows control to shift to new shareholders if these new shareholders acquire stock in an unrelated transaction.

Section 9522 of the Budget Bill primarily creates corporate level gain for two forms of transactions: (1) a section 355 distribution followed by a section 1032 issuance (a "spin off /issuance transaction") in which the issuance shifts control to outsiders, and (2) a section 355 distribution followed by an acquisitive reorganization (a "spin off/merger transaction") in which the acquisitive reorganization shifts control to outsiders. For example, assume Distributing owns all of Controlled, each of which are worth 50x as stand alone entities. In a spin off/issuance transaction, Distributing distributes Controlled, and Controlled issues its stock (worth 51x) to new shareholders pursuant to a prearranged plan. In this circumstance, section 9522 requires Distributing to recognize gain on its Controlled stock because the new shareholders acquire 51 percent control of Controlled. A similar result follows in a spin off/merger transaction if Controlled merges into Acquiring with the Acquiring shareholders owning 51 percent of Acquiring upon completion of the transaction. Lastly, section 9522 creates corporate level gain if Distributing issues its stock or merges after the section 355 distribution and the issuance or merger shifts 51 percent control to new shareholders.

IV. Purported Policy of the Proposal

The legislative history associated with the Budget Bill fails to describe the rationale behind section 9522. However, it is my understanding that the driving forces behind the proposal are certain spin off/merger and spin off/issuance transactions that resemble Distributing sales of Controlled stock.[1] This policy concern is consistent with the policy of

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[1] It is my understanding that section 9522 of the Budget Bill may also be partly motivated by device and continuity concerns. This submission does not address

section 355(d).

In the standard spin off/issuance transaction that resembles a sale, the spin off/issuance is combined with a transfer of cash from Controlled to Distributing. For example, assume Distributing owns all of Controlled. Controlled borrows cash from a bank, distributes the cash to Distributing, and Distributing distributes Controlled. Pursuant to a prearranged plan, Controlled subsequently issues stock to new shareholders in exchange for cash equal to the amount borrowed with Controlled using these proceeds to retire the bank loan. The net result is a spin off/issuance transaction that effectively amounts to a sale. Distributing has effectively disposed of its Controlled stock in exchange for received cash from the new shareholders.

The standard spin off/merger transaction of concern is similar to the spin off/issuance transaction just described. In this instance, Controlled borrows cash from a bank, distributes the cash to Distributing, and Distributing distributes Controlled. Pursuant to a prearranged plan but separated by an independent shareholder vote (see Rev. Rul. 75-406, 1975-2 C.B. 125.), Controlled subsequently merges into Acquiring with Acquiring using its resources to retire the bank loan. The net result is essentially the same as above. Distributing has effectively disposed of its Controlled stock in exchange for cash from Acquiring.

V. Policy/Statutory Mismatch

The chief policy behind section 9522 of the Budget Bill has merit, being consistent with the disguised sale concern that led to the 1990 enactment of section 355(d). However, the statutory language of section 9522 does not comport with its intent. The statutory language wrongfully focuses on shareholder control of the distributing and controlled corporation stock rather than on asset movements between the distributing and controlled corporations, the proposal's real concern.

Because section 9522 of the Budget Bill focuses on shareholder control rather than corporate level assets transfers, the proposal incorrectly creates a corporate level tax for certain transactions that do not resemble sales. For example, assume Distributing owns all of Controlled (worth 50x). Distributing distributes Controlled, and Controlled issues its stock to new shareholders in exchange for 51x cash. The transaction does not involve any asset movements between Distributing and Controlled. Under section 9522, Distributing has corporate level gain on the Controlled stock even though the transaction does not resemble a sale. Distributing has disposed of its Controlled stock, but has received nothing in return. Section 9522 similarly creates corporate level gain for spin off/mergers where the shareholders of Acquiring acquire 51 percent control of Controlled even if Distributing receives nothing in return (any stock of Acquiring instead being ultimately held by the Distributing and Acquiring shareholders).

In addition, the improper shareholder focus of section 9522 of the Budget Bill fails to create gain for certain spin off/issuance and spin off/merger transactions which resembles sales. For example, assume Distributing owns all of Controlled (worth 50x). Controlled borrows 20x cash from a bank, distributes the 20x cash to Distributing, and Distributing distributes Controlled. Pursuant to a prearranged plan, Controlled subsequently issues stock to new shareholders in exchange for 20x cash with Controlled using these proceeds to retire the bank loan. The net result is a spin off/issuance transaction that effectively amounts to a partial sale. Distributing has effectively sold 20x of its Controlled stock in exchange for the 20x cash received from the new shareholders. Yet, section 9522 does not apply because the

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these concerns, but the device and continuity requirements appear to provide weak policy support for section 9522. First, there is no reason for Congress to impose a different continuity standard for section 355 distributions versus the continuity standard used in connection with acquisitive section 368 reorganizations. Second, corporate level gain recognition is inconsistent with device since device is a shareholder level concern rather than a corporate level concern.

new shareholders have not acquired a more than 50 percent interest in Controlled. In a similar vein section 9522 also would not apply to essentially the same factual situation involving a spin off/merger transaction.

VI. Conclusion

Although the imposition of corporate level tax on spin off transactions resembling corporate sales appears well-founded, Congress should substantially revise the statutory language of section 9522 of the Budget Bill. The redrafted language should focus on movements (cash/asset distributions and/or liability assumptions) between the distributing and controlled corporations. It is these asset transfers that create the potential for disguised corporate sales rather than post-spin off shareholder control of the distributing and controlled corporations.

STATEMENT
OF
THE FAIR INSURANCE COALITION
IN RESPONSE TO
THE HOUSE COMMITTEE ON WAYS AND MEANS
REQUEST FOR COMMENTS
ON
NEW REVENUE PROVISIONS IN THE
PRESIDENT'S FISCAL YEAR 1997 BUDGET

This statement is respectfully submitted on behalf of the Fair Insurance Coalition in response to the Committee's request for comments on revenue provisions that were included in President Clinton's fiscal year 1997 budget but not in the Balanced Budget Act of 1995. The Coalition appreciates the Committee's interest in public comments on the Administration's new revenue proposals and welcomes the opportunity to express its strong opposition to one of these proposals in particular -- the proposal to modify the taxation of captive insurance companies and their policyholders. As explained below, the Coalition believes that this proposal could have negative consequences for both the domestic captive industry and the many U.S. taxpayers that receive economically efficient insurance protection through domestic and foreign captive insurance companies. The Coalition respectfully urges the Committee to reject this ill-conceived proposal.

BACKGROUND ON CAPTIVE INSURANCE

As the Committee is aware, the cost of insurance is a major expenditure for U.S. businesses, associations and other entities. In order to be competitive, these taxpayers must find ways to control their insurance costs and to manage their risks effectively. Thus, as the costs of attaining adequate coverage have risen in the traditional commercial insurance markets, these entities increasingly have turned to alternative sources of insurance coverage, such as captive insurance companies (or captives). Further, taxpayers have turned to captives in order to receive coverage that is unavailable in the traditional markets.

Captives typically are insurance companies that have been established in order to meet the particular risk management needs of their owners. Significant business benefits flow from insuring through a captive, including: lower costs of insurance coverage; protection against loss from activities for which coverage is unavailable in the traditional commercial markets; centralized claims management; better control over cash flow and risk management; and reduced exposure to the volatility of the commercial insurance markets. As a result of these and other nontax benefits, a large number of U.S. businesses in a wide range of industries - - as well as hospitals, universities, associations, and other entities - - currently receive insurance protection from domestic and foreign captive insurance companies. Indeed, over $20 billion in premiums is associated with captive insurance companies. Over 350 captive insurance companies are domiciled in States such as Vermont, Georgia, Delaware, Illinois, Tennessee, Colorado, and Hawaii.

The Federal tax laws governing captives and their policyholders have evolved through years of costly and burdensome litigation between the Internal Revenue Service (IRS) and taxpayers addressing whether a relationship between a captive and its policyholders constitutes insurance for Federal tax purposes. If the relationship constitutes insurance, the insured shareholders can deduct their premium payments and the captive is taxed as an insurance company under Subchapter L of the Internal Revenue Code. Although IRS agents have been dissatisfied with the results of some of this litigation, the ensuing judicial decisions have produced a workable set of principles governing the tax treatment of captives and their policyholders. These judicial decisions flow from the Supreme Court's holding in *Helvering v. Le Gierse*, 312 U.S. 531 (1941), that a relationship must involve both risk shifting and risk distribution in order to be treated as insurance for Federal tax purposes. For example, these cases, which were addressed in the Tax Court as well as in a variety of circuits, establish that:

- captives must be adequately capitalized, must deal with their owners at arm's-length, and must be subject to prudent regulatory control by the jurisdiction in which domiciled;

- transactions between a parent shareholder and its wholly-owned captive generally will not constitute insurance if the captive insures only the parent's risks;
- transactions between a captive and its brother-sister affiliates will constitute insurance as long as certain requirements are satisfied; and
- transactions between captives that have multiple unrelated owners (*i.e.*, group captives) and their owners create adequate risk shifting and risk distribution, and will be respected as insurance.

See *Humana, Inc. v. Commissioner*, 881 F. 2d 247 (6th Cir. 1989); *Malone & Hyde, Inc. v. Commissioner*, TC Memo 1993-585; *AMERCC, Inc. v. Commissioner*, 96 T.C. 18 (1991), *aff'd* 979 F. 2d 162 (9th Cir. 1992); *The Harper Group and Includible Subsidiaries v. Commissioner, 96 T.C. 45 (1991), aff'd* 979 F. 2d. 1341 (9th Cir. 1992); and *Sears Roebuck and Co. v. Commissioner*, 96 T.C. 61 (1991), *aff'd* 972 F. 2d 858 (7th Cir. 1992). See, also, *Carnation Company v. Commissioner*, 640 F. 2d 1010 (9th Cir., 1981); *cert denied* 454 U.S. 965 (1981); *Beech Aircraft Corporation v. United States*, 797 F. 2d. 920 (10th Cir. 1986); *Crawford Fitting Company v. U.S.*, 606 F Supp 136 (N.Dist. Ohio, E. Div., 1985); *Commissioner v. Treganowan*, 183 F. 2d 288 (2d. Cir. 1950), *cert. denied* 340 U.S. 853 (1950).

These judicially-established principles have formed the foundation for the structure of today's captive insurance arrangements. For example, group captives that shift risks among the owners have been formed in reliance upon these principles. Similarly, many captive insurance companies have agreed to shift and distribute risk by insuring a sufficient level of third-party risk.

THE ADMINISTRATION'S PROPOSAL

The Treasury currently is asking the Congress to modify the principles provided by the courts and to enact arbitrary rules that the IRS was not successful in establishing through litigation. Although the specifics of Treasury's proposal are extremely complex, the proposal in essence would impose a new requirement that, in order to constitute an insurance company for Federal tax purposes, no more than 50 percent of a captive's premiums could be derived from insuring risks of its "large shareholders." For this purpose, a large shareholder would be broadly-defined as including both (1) any 10-percent shareholder, and (2) any person "related" to such a shareholder (applying attribution and constructive ownership rules). Moreover, Treasury would have broad regulatory authority to define as related a person who otherwise would be unrelated -- such as a client or supplier of a large shareholder. If a captive failed to satisfy this new definition cf insurance company, its 10-percent shareholders, as well as any persons related to those shareholders, would not be able to deduct premiums paid to the captive. Further, the captive would not be subject to the specially-crafted rules for insurance companies under Subchapter L of the Internal Revenue Code and would not be eligible for tax exemption under Section 501(c)(15) (relating to certain small insurance companies).

The proposal also would provide a number of additional rules for foreign captives. For example, a new category of foreign personal holding company income would be created with respect to premiums received from, and claims paid to, large shareholders. Further, as suggested above, if a foreign captive failed to meet the new definition of insurance company, it would not be able to claim reserve deductions for its insurance policies or to use any other subchapter L rules for purposes of determining the amount passed through to its shareholders under Subpart F. In addition, even though the captive might fail to be an insurance company for Federal tax purposes, the current excise tax applicable to premiums paid by a U.S. company to a foreign insurer still could apply to premiums paid by large shareholders if the ultimate insured claimed a deduction for premiums paid.

The proposal also would allow Treasury to impose new administrative burdens upon a broad range of taxpayers and transactions. Specifically, every person who directly or indirectly received insurance from a company of which it is a shareholder, or who received insurance from a company that has a shareholder to which the insured is considered related, would have to comply with recordkeeping and information reporting requirements set forth by Treasury. The penalty for failing to comply with these requirements would be denial of a deduction for premium payments for the insurance -- even if the person otherwise would have been entitled to such a deduction.

The proposal would be effective for taxable years beginning after the date of enactment.

PROBLEMS WITH THE ADMINISTRATION'S PROPOSAL

The Coalition believes that the Administration's proposal could have drastic adverse consequences for domestic captive insurance companies, as well as the many U.S. businesses and other entities that have sought to obtain insurance, decrease their insurance costs, and better manage their risks through the alternative insurance markets. As explained below,

- enactment of the proposal would significantly increase the costs of doing business for many U.S. taxpayers, would threaten the solvency and viability of many captives, and could drive the domestic captive industry offshore (due to State law restrictions on the amount of third-party risks a captive may insure);
- the proposal would decimate years of judicially-crafted law on which taxpayers have relied, without any justifiable policy rationale;
- the proposal would add increased complexity to the Internal Revenue Code and would impose substantial new compliance burdens on American taxpayers;
- the proposal fails to address a number of critical technical issues with significant policy implications; and
- **according to the Joint Committee on Taxation, the proposal would result in revenue loss -- not gain -- to the Federal Government over a 10-year period.**

Thus, the Coalition strongly urges the Committee not to adopt the Administration's proposal in any form at any time.

A. Enactment of the proposal would drastically increase the costs of doing business for many U.S. taxpayers, would threaten the solvency and viability of many captives, and could drive the domestic captive industry offshore.

As indicated above, today's captive insurance arrangements have been structured as insurance relationships based on workable principles established by the courts after years of litigation. If the Administration's proposal were enacted, many of these relationships suddenly would no longer qualify as insurance for Federal tax purposes. As explained below, such a change in the law could have crippling economic consequences, not only for the many U.S. businesses and associations that manage their risks through captives, but also for the over 350 domestic captives that provide revenues and jobs in States such as Vermont, Georgia, Delaware, Illinois, Tennessee, Colorado and Hawaii.

For example, if the proposal were enacted, businesses that receive insurance protection through domestic and foreign captives would see their tax burdens substantially increased due to the loss of premium deductions (and, in some cases, the deemed receipt of additional income under Subpart F). This additional tax burden not only would increase their costs of doing business, but also could make it too expensive for them to insure certain risks for which protection only has been available through the alternative risk markets. If these risks ultimately were to occur, the lack of insurance could have negative consequences not only for the uninsured business, but also for its shareholders, creditors, and any persons directly or indirectly harmed by the occurrence of the risk. In addition, the increased costs of insuring through a captive would make captive insurance a less desirable (if not undesirable) product, to the detriment of the captive insurance industry. Moreover, because captives would be subject to different Federal tax rules than their competitors in the traditional markets, they would be placed at a severe competitive disadvantage.

Admittedly, it is possible that a captive might try to restructure its relationships in order to meet the Administration's new definition of an insurance company and to avoid the increased tax costs described above. In such a case, the captive would have to substantially increase the amount of third-party risks it writes. However, experience shows that captives that insure a large amount of third-party risks are less able to predict and to control their exposure to loss, and are more likely to become insolvent.

Indeed, precisely because of concerns regarding the solvency of captives that insure a large amount of unrelated business, domestic captive jurisdictions, such as Vermont, tend to limit the amount of unrelated business that can be written by a captive. Thus, absent a change in State law that would allow captives to engage in activity that could threaten their solvency, many U.S. captive insurance companies may be unable to restructure their activities to satisfy the new definition of an insurance company. As a result, U.S. businesses and associations may turn their backs on domestic captives, and seek insurance protection from captives in foreign jurisdictions that allow larger amounts of third-party business in captives.

B. The proposal would decimate years of judicially-crafted law on which taxpayers have relied, without any justifiable policy rationale.

As explained above, the courts have established principles regarding when captive relationships are, and are not, considered to be insurance for Federal tax purposes. Although the IRS may not be satisfied by all of the principles established by the courts, these principles have been abided by, and relied upon by, captive insurance companies and their policyholders in structuring their business affairs. It would be grossly unfair to change these principles now and to adopt an arbitrary new definition of insurance that is far stricter than that established by the courts.

Moreover, the judicially-established principles already ensure that captive relationships involve a sufficient amount of risk shifting and risk distribution. Thus, there is no policy reason to replace these principles with a formulaic definition of what constitutes insurance. Indeed, the definition of insurance that the Administration would impose is internally inconsistent and makes little sense from a risk distribution perspective. For example, the proposal arbitrarily would conclude that a captive that is equally-owned by each of three parties does not adequately distribute risk. However, in such a case, two-thirds of the captive's business would be unrelated to each owner; this is well over the proposal's 50-percent litmus test for risk distribution.

Further, the Administration's proposal is completely at-odds with Congressional intent in enacting the Risk Retention Act of 1981. That legislation was intended to encourage the formation of group captives in order to increase competition in the product liability insurance marketplace and to reduce the subjectivity involved in underwriting risks. By contrast, the Administration's proposal would discourage the formation of group captives, would impair competition in the insurance marketplace, and, in effect, would penalize group captives that have carried out legislative intent by underwriting risks based upon the experience of their owners.

Finally, the Administration's proposal cannot be justified on the ground that captives are vehicles for tax abuse and avoidance. As explained above, numerous U.S. businesses and other groups have turned to the alternative insurance markets primarily for nontax, business reasons. For example, a business that insures through a captive can reduce its risk management costs, protect itself against otherwise uninsurable risk, centralize claims management activities, and reduce its exposure to the volatility of the commercial insurance markets. Thus, no tenable tax policy justifies the economic burden the Administration's proposal would impose upon the captive insurance industry.

C. The proposal would add even more complexity to the Internal Revenue Code and would impose unjustifiable new administrative burdens on American taxpayers.

As indicated above, the Administration's proposal would replace principles that taxpayers understand with a new set of highly-complex statutory rules. In addition, the proposal would provide Treasury with the opportunity to add yet another layer of complexity through the promulgation of regulations on a variety of issues -- such as when parties who are not otherwise related should be treated as related for purposes of the proposal. It clearly would be inappropriate to add such needless complexity to our Nation's tax system. Such action would exacerbate the current level of frustration that taxpayers have with the tax laws and would be inconsistent with Congressional interest in simplifying and reforming the Internal Revenue Code.

Moreover, the proposal would subject a wide range of taxpayers to increased administrative burdens without policy justification for the substantive provisions. For example, as indicated above, every person who directly or indirectly receives insurance from a company of which it is a shareholder, or who receives insurance from a company that has a shareholder to which the insured is considered related, would have to comply with recordkeeping and information reporting requirements set forth by Treasury -- regardless of whether the insurance company satisfies the proposal's definition of an insurance company. Complying with these increased administrative burdens would require the devotion of resources and the expenditure of money that otherwise could be devoted to productive business use.

D. The proposal fails to address a number of critical policy and technical issues.

Notwithstanding the complexity of the Administration's proposal, the proposal fails to address a number of issues with significant policy implications. For example, it provides no guidance as to how the new rules would affect captives that are controlled foreign corporations, but that have made elections to be taxed as domestic insurance companies under Section 953(d) of the Internal Revenue Code. Further, it contains no transition rules for companies that suddenly would find that they no longer are insurance companies for Federal tax purposes. Resolution of these, and other, technical issues would have significant policy consequences and almost certainly would increase the complexity of the proposal and its burdens on U.S. businesses even further.

E. The proposal is not just a policy loser -- it is a REVENUE LOSER.

Although the Administration has offered its proposal as a mechanism for raising revenue, the Congressional Joint Committee on Taxation (JCT) has estimated that the proposal actually would **lose** revenue ($23 million) over the 10-year period following enactment. The JCT estimates that the proposal would raise revenue only in its first two years (thereby generating a small net revenue gain in the 5-year period following enactment); however, in each of the following eight years, the JCT estimates that the proposal would lose revenue. Thus, the proposal clearly should not be viewed as a way to raise revenue.

RECOMMENDATION

For the reasons set forth above, the Coalition strongly urges the Committee not to include the Administration's proposal in any tax legislation, this year or in the future. The Coalition appreciates the Committee's interest in its views on this significant issue.

FLAHERTY &
CRUMRINE
INCORPORATED

INVESTMENT COUNSEL

301 E. Colorado Blvd. · Suite 720 · Pasadena, California 91101 · (818) 795-7300

May 14, 1996

Phillip D. Moseley, Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Moseley: In re: Request dated 4/15/96 for written comments on new revenue provisions in President's fiscal year 1997 budget

We wish to comment on the Administration's proposal to reduce the intercorporate dividends received deduction ("DRD") from 70% to 50%.

Flaherty & Crumrine Incorporated (**"F&C"**) is an investment adviser registered with the SEC that specializes in the management of preferred stock portfolios. Our clients include three New York Stock Exchange listed closed-end investment companies and a small number of large corporate investors. Assets under F&C's management total approximately $1.2 billion, the great bulk of which is preferred stocks.

The three publicly held investment companies for which F&C is the investment adviser, Preferred Income Fund, Preferred Income Opportunity Fund and Preferred Income Management Fund, have submitted a separate letter covering the effects of the proposal on over 30,000 shareholders of those funds. The discussion here will supplement, rather than overlap, those comments.

ANTICIPATED IMPACT OF THE PROPOSED REDUCTION IN THE DRD

From our viewpoint as practitioners in the preferred stock market, we believe the proposed cut in the DRD would alter important economic relationships and result in:

- **Substantial shrinkage of the preferred stock market** which is an important sector of the capital markets.

- Predictable shifts in financing and investment practices that **challenge the expectation of a revenue gain to the Treasury.**

Furthermore, these concerns do not depend upon any "futurist vision." Rather, they are **based upon well demonstrated, currently operating forces** that would clearly be accentuated by a reduction in the DRD. Our reasoning follows.

SIGNIFICANCE OF THE U.S. PREFERRED STOCK MARKET

The United States has the **only well developed preferred stock market in the world**. Traditionally, the DRD has allowed domestic issuers, particularly utilities and banks, to obtain lower cost equity capital in the preferred stock market by partially shielding corporate investors from an additional layer of corporate taxation. Foreign issuers commonly access the U.S. market, often taking advantage of favorable tax treatment at home or under treaty with the United States.

May 14, 1996

The preferred stock market also provides a **"safety valve" for companies in need of equity capital.** This was best demonstrated by the **crisis in the U.S. banking industry in the early 1990's.** When the banks were unable to raise additional equity capital in the common stock market, their needs were **accommodated through the issuance of preferred stocks.** To this day, only preferreds eligible for DRD can meet this need for U.S. banks, in particular, since banking regulators do not allow "Tier 1" capital treatment for the more recently created so-called "tax deductible preferreds," which are based upon a debt instrument issued to an intermediary and are not eligible for the DRD.

Preferred stock dividends account for a **disproportionately large share of total dividend income received by corporate investors.** The yields of preferreds are much higher than those of common stocks, and the majority of all outstanding DRD eligible preferreds are owned by corporations. We estimate that preferred stock dividends received by corporate investors amount to roughly $3 billion per year, which is a substantial portion of the total dividend income of corporate investors. Thus, **structural changes in the preferred stock market** that take place in response to a change in the DRD will have **a substantial impact on the amount of tax revenues gained or lost.**

CURRENT STATE OF THE PREFERRED STOCK MARKET

As shown in Exhibit I, we estimate that the market value of preferred stocks outstanding on December 31, 1995 consisted of roughly **$66 billion of DRD eligible preferreds** and almost **$26 billion of non-DRD eligible** preferreds. The latter group included over $14 billion of "tax deductible preferreds" plus some foreign and a few miscellaneous issues.

A more dynamic view of the market is provided by the chart in Exhibit II which shows the dollar amount of new issues and redemptions of DRD eligible preferreds and non-DRD eligible preferreds from 1991 to the present. Since **"tax deductible preferreds"** were introduced in late 1993, they have been **rapidly replacing DRD eligible preferreds.** From the start of 1994 through May 9, 1996, almost $19 billion of "tax deductible preferreds" were issued while over $8 billion net of DRD eligible preferreds were redeemed.

Many currently outstanding DRD eligible preferreds" will become redeemable over the next two years. A further look at the chart in Exhibit II reveals that over $25 billion of DRD eligible preferreds were issued in the three years from 1991 through 1993. Many of those preferreds become callable by their issuers five years after their initial offering dates, and they are highly likely to be redeemed when that occurs given the substantial decline in interest rates since the early 1990's. It is an open question at this point whether the preferreds that are refinanced will be replaced with debt instruments, "tax deductible preferreds," or DRD eligible preferreds.

IMPACT OF A DRD CUT ON PREFERRED STOCK INVESTORS

Reducing the DRD to 50% would obviously make DRD eligible preferreds less attractive to corporate investors who are the marginal buyers of these securities. All other things being equal, the **after-tax yields to such investors would fall**, causing the market prices of DRD eligible preferreds to decline also. We estimate **potential price depreciation in the range of 1 1/2% to 7%** from current market levels, depending upon the dividend rate and the other terms of the specific issue of preferred stock in question.

May 14, 1996

The **interaction of DRD eligible preferreds with other market sectors** would also be an important factor if the DRD were cut. If only corporate investors were involved, reestablishing market equilibrium could require prices to decline and pre-tax yields to rise enough to bring preferred yields after corporate taxes back to the levels existing prior to the DRD cut. However, that sort of market adjustment would also cause the pre-tax yields on DRD eligible preferreds to rise relative to interest rates on bonds. Ultimately, that would make DRD eligible preferreds competitive with fully taxable bonds on a pre-tax yield basis, and **"total return investors"** such as pension funds would then become **potential buyers of DRD eligible preferred** stocks.

In a broad range for the DRD around 50%, we believe **DRD eligible preferreds would be "neither fish nor fowl."** Lower after-tax yields of DRD eligible preferreds would cause some corporate investors to lose interest. At the same time, the pre-tax yields of such preferreds would not be high enough to stimulate many total return investors to reorient their investment practices to include such preferreds. DRD eligible preferreds would be cushioned to a degree against further price decline, but the market's "audience" would shrink. This would be matched by shrinking supply, as discussed in the following section, which would **greatly reduce the depth of this important market sector.**

IMPACT OF A DRD CUT ON THE ISSUANCE OF PREFERRED STOCKS

Domestic corporations have a **strong bias toward financing with debt instead of equity**, particularly in good economic times. It is simply a matter of interest being deductible for income tax purposes while dividends are not. **A lower DRD would accentuate this bias** in favor of debt financing.

The proposed reduction of the DRD would **further increase the incremental cost of capital of issuing DRD eligible preferreds** versus financing with debt. The dividend rates on such preferreds would certainly rise relative to interest rates on bonds and other forms of debt, as discussed in the section immediately above. Since dividend payments are not deductible, higher dividend rates on newly issued preferreds would increase the issuer's after-tax cost of capital dollar for dollar with no corresponding increase in the cost of debt financing.

The experience of the last several years is abundant proof that corporate **financing decisions are extremely sensitive to the after-tax cost** of issuing DRD eligible preferreds versus debt. "Tax deductible preferreds", which stem from underlying debt, have replaced DRD eligible preferreds at a rapid pace, even with the DRD at 70%. Reducing the DRD to 50% in the face of the substantial potential redemptions of DRD eligible preferreds over the next several years would **open the floodgates for replacement of equity financing by debt.**

We are aware that the budget for fiscal 1997 contains some newly **proposed restrictions on "tax deductible preferreds."** Even if the features of those securities that are most "equity like" were prohibited, the **incentive and the means to replace preferred equity with debt would still exist.** Wall Street has learned how to package and sell corporate debt instruments to the retail market. That will not go away.

IMPLICATIONS FOR REVENUES TO THE TREASURY

The proposal to cut the DRD to 50% is **not just an incremental change** that would increase Treasury revenues without changing much else. It would bring the DRD to a level that would **set in motion structural changes** in the market for DRD eligible preferreds. Those changes must be taken into account in estimating the revenue impact.

May 14, 1996

Our analysis of the revenue impact is based on a **computer model** developed by F&C We will comment here only on a conceptual level, but we are making the full model **available to the staff of the Joint Committee on Taxation**. We hope it will provide a "worm's eye" view of the technical market ramifications of the proposal that might not be spotted by conventional macro models.

We should point out that the system is producing **tax revenues that might not exist if there were no DRD**. When one corporation pays a dividend to another, an effective tax of 10.5% is imposed. If the same transaction took place in the form of interest on debt, the interest deduction to the payer would offset the interest income taxable to the payee, and no tax liability would be created on balance. In actuality, the process would be considerably more complex than this example, of course, but the point remains the same. It is quite **possible to reduce tax revenues** by raising the tax rate on a financial sector **if, as a result, the financial sector shrinks in size.**

As the proposal applies to DRD eligible preferreds, actual tax revenues would depend on a number of **critical variables**. Several of the most important ones are very likely to have a negative revenue impact. These include **a resulting shrinkage in the universe of DRD eligible preferreds**, a strong preference for **refinancing retired preferreds through the issuance of debt** including "tax deductible preferreds", and a general **reduction in holdings of equity securities by corporate investors**. It is less clear **how corporations would redeploy surplus funds** no longer invested in equity securities, but we doubt that the range of possibilities is wide enough to be a driving factor. Numerous minor factors also play a part in the analysis, but they are not significant next to these critical variables.

We think the best use of our model is to **test the sensitivity of revenue projections to changes in the critical underlying assumptions**. This process indicates that cutting the DRD as proposed would produce no increase in revenues from DRD eligible preferreds if, as a result, issuers redeemed or refunded as little as one-sixth of the outstanding DRD eligible preferreds. Recognizing the lack of precision inherent in predicting the future, we have considered an alternative case of the market being required to shrink by one-third, or twice as much as the model indicates would produce break-even revenues. In each case, we conclude that reducing the DRD with respect to DRD eligible preferreds would be **more likely to reduce overall tax revenues than to increase them.**

We would be more than **willing to share our model** with the Committee.

THE "FAIRNESS ARGUMENT"

We have heard it argued that the DRD is not fair because it allows a corporate investor holding a diversified portfolio of stocks to pay a tax that is significantly lower than an individual investor would pay in the same situation. This argument ignores the reality that all taxes are ultimately borne by individual consumers and investors. Corporate investors are merely one step higher up the investment "food chain." It is **impossible to make the system fairer by taking more money out of the chain** before it gets to them. The system already falls between double and triple taxation of the same dollars before individuals get the benefit of them.

APPLICATION OF MODEL TO COMMON STOCKS

We have confined the foregoing comments to preferred stocks only because that is where our special expertise lies. Nonetheless, we believe that **many of the same arguments also apply to common stocks**. The obvious exception is that the portion of

May 14, 1996

common stocks owned by corporate investors is much too small to cause significant price adjustments or a shrinkage of that market. The arguments for reducing multiple layers of taxation apply with full force.

CONCLUSION

It is essential to **distinguish between corporate welfare and the structures that make the capital markets in United States so efficient** and the envy of the rest of the world. Reducing the DRD is a proposal that has come up many times before as a potential revenue raiser and has been turned down as counterproductive. We believe that any revenue produced by cutting the DRD would be meager in relation the administration's budget estimates and would come at a cost of damaging the DRD eligible preferred stock market. The recent shrinkage of that market would escalate, and its traditional base of corporate investors would be fragmented. This raises **issue of whether the market would have the capacity to rise to the occasion again if there were another crisis** on the scale of the domestic banking industry's problems in the early 1990's.

Very truly yours,

Robert T. Flaherty
President

EXHIBIT 1

SIZE OF THE PREFERRED STOCK MARKET AS OF 12/31/95

($ IN BILLIONS)

	$ OUTSTANDING
DRD ELIGIBLE	
PUBLIC	
Adjustable Rate	$4.63
Sinking Fund	8.29
Perpetual	33.69[1]
Auction or Remarketed	14.79[2]
PRIVATE (primarily sinking funds)	5.00[3]
TOTAL DRD ELIGIBLE	$66.40
NON-DRD ELIGIBLE	
MIPS (or similar structures)	$14.44
Foreign Issuers	9.98
REITS	1.57
TOTAL NON-DRD ELIGIBLE	$25.99

Source: Bosley Financial, Inc. and Salomon Brothers Inc.

(1) Includes "old money" issues totaling $2.11 billion.
(2) Source: Lehman Brothers, includes private placements.
(3) Estimate by Salomon Brothers Inc.

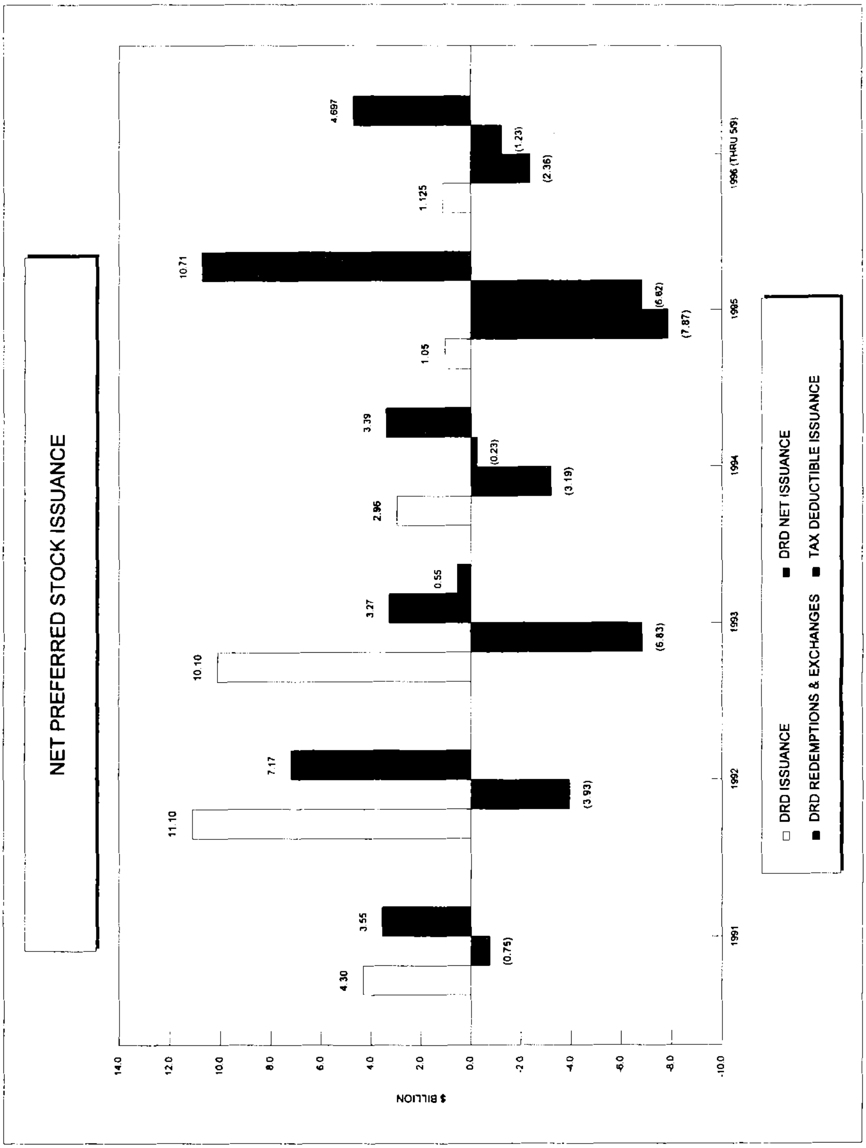
NET PREFERRED STOCK ISSUANCE
$ BILLION
14.0
12.0
10.0
8.0
6.0
4.0
2.0
0.0
-2.0
-4.0
-6.0
-8.0
-10.0
1991
1992
1993
1994
1995
1996 (THRU 5/9)
4.30
(0.75)
3.55
11.10
(3.93)
7.17
10.10
(6.83)
3.27
0.55
2.95
(3.19)
(0.23)
3.39
1.05
(7.87)
(6.82)
10.71
1.125
(2.36)
(1.23)
4.697
DRD ISSUANCE
DRD REDEMPTIONS & EXCHANGES
DRD NET ISSUANCE
TAX DEDUCTIBLE ISSUANCE

EXHIBIT 2

Girard Miller, President and Chief Executive Officer

ICMA RETIREMENT CORPORATION

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777 North Capitol Street, NE
Washington, DC 20002-4240
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May 14, 1996

Chairman Bill Archer
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Archer:

I am writing with respect to your solicitation for comments on President Clinton's fiscal year 1997 budget request. I am limiting my remarks strictly to the provisions that affect section 457 deferred compensation plans for public sector employees.

The ICMA Retirement Corporation represents more than 4,500 public employers and more than 240,000 of their employees for whom we administer retirement plans. Our exclusive concern is the retirement security of public sector employees.

As you know, the requirement that section 457 plan assets remain under the ownership of the Employer, subject to the claims of its general creditors until made available to the plan participant, has become controversial in light of events in Los Angeles County and Orange County, California.

We support the provision in the Administration's budget proposal that would enable public sector employers to establish trusts so that 457 assets may only be used to pay benefits for plan participants and beneficiaries.

While endorsing President Clinton's inclusion of this language in his budget request, we also wish to acknowledge your critical role in initiating the process to correct this serious flaw in the statutes.

The Retirement Corporation wishes to be on record as strongly supporting measures to protect the retirement savings of public sector employees. We strongly urge Congress and the Administration to enact legislation that contains these important section 457 provisions.

Thank you for your attention to our views on legislation that will benefit millions of state and local government employees. Your continued active support is appreciated.

Sincerely,

GM/kmh

Larry F. Altenbaumer
Chief Financial Officer,
Treasurer and Controller

illinova

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Decatur, IL 62525-1805
Tel 217 424-6678
Fax 217 362-7417

May 13, 1996

Honorable Bill Archer
Chairman
Committee on Ways & Means
United States House of Representatives
1102 Longworth Building
Washington, D.C. 20515-6348

Dear Mr. Chairman:

This letter is filed in opposition to one of the "revenue raisers" contained in President Clinton's FY 1997 budget document.

The Treasury Department proposes to change the tax treatment of captive insurance companies to establish a statutory threshold of 50% unrelated business risk to qualify a captive for tax treatment as an insurer. The proposed change would have a significant impact on the operating costs of Illinova Corporation.

Illinova is establishing a new captive to serve many of the property, liability and similar insurance needs of Illinova and its subsidiaries, Illinois Power Company, Illinova Generating Company, Illinova Energy Partners, and Illinova Power Marketing, Inc. This new captive will enable Illinova to achieve considerable savings over its current practice of using outside commercial insurance carriers and will greatly assist the company in addressing its risk management needs. Illinova's captive will be organized and capitalized like any other insurance company, with its own loss reserves and pricing practices based on actuarial science.

Because Illinova's insurance company will provide services to its other affiliates, it will not meet the 50% unrelated business test, even though it will act as an insurance company in every respect. If this change in the tax law is enacted by Congress, it will cost Illinova over $1.0 million per year. Illinois Power is the largest company in the Illinova family, so much of the cost ultimately could be borne by the ratepayers.

The proposal would penalize Illinova for choosing a more cost-effective insurance alternative and establish an unfair double standard for insurance. Illinova's premium payments would lose their status as a tax-deductible expense, while premiums paid by others to outside commercial insurance companies would still be treated as deductible business expenses.

There are other reasons that the captive insurance proposal is bad policy:

- The proposal would severely hamper the domestic captive insurance industry. Captive insurers are a legitimate and important option for companies who chose them for reasons of cost, availability of insurance, and other valid business reasons. The industry is an important business in many states. Illinois, for example, recently enacted laws to encourage formation of captive insurance companies.

- Many of the companies that rely on this form of insurance would face higher costs, as Illinova's projections attest.

- Although the Treasury Department justifies its proposal by citing a "lack of clarity under current law," there is in fact ample case law. A new statute would be disruptive and most likely launch a new round of litigation involving many of its provisions.

On balance, the short-term revenue gains from this proposal do not justify the negative consequences for American companies large and small. We believe that this proposal should not become law.

Sincerely,

Larry F. Altenbaumer

c: Hon. Phil Crane

ISDA
INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC

1270 Avenue of the Americas
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February 26, 1996

The Honorable Bill Archer
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

The International Swaps and Derivatives Association ("ISDA") is a trade association representing 277 leading financial institutions worldwide that engage in privately negotiated derivatives transactions. ISDA is therefore vitally concerned with the proposals made by the Administration to impose a new tax regime with respect to certain hedging transactions.

As the enclosed memorandum demonstrates, the proposals would make a significant change in long standing tax policies and thus pose important questions of substance and scope. We therefore urge that your committee take no action on these proposals until after full hearings have been held with an opportunity for all interested parties to comment. Pending such hearings, ISDA and its representatives would welcome the opportunity to discuss our concerns with you and your staff.

Very truly yours,

Gay Evans

Gay Evans
Chairman

attachment

cc: Honorable Sam Gibbons

International Swaps and Derivatives Association, Inc.

February 23, 1996

Comments on Administration Tax Proposal Concerning Equity Swaps and Similar Transactions

Executive Summary

On January 12, 1996, the Administration announced that it was considering tax legislation that would impose a new tax regime on certain hedging transactions (the "Proposal"). On behalf of the International Swaps and Derivatives Association ("ISDA"), we respectfully submit the following comments on the Proposal:

- The Proposal would tax the appreciation in a position before that appreciation has been realized. The realization requirement has been a sound guide to fairness and administrability in our system, and exceptions to that requirement should be made only after adequate consideration. ISDA believes that the Proposal's suspension of the realization requirement for certain hedging transactions should not be made without an appropriate period of examination and consideration.

- ISDA believes that the Proposal's "constructive sale" rule for certain hedging transactions should not be enacted because it is based on a flawed analogy between certain hedges and actual sales and because it imposes tax before cash is available to pay that tax.

- ISDA believes that the scope of the Proposal is poorly defined and thus will unintentionally deter many economically useful transactions.

- ISDA believes that the enactment of a "constructive sale" rule will have unintended consequences, in large part because the suspension of the realization requirement opens a host of questions that have not been considered or reviewed by the Administration or Congress.

Comments

ISDA is an international organization whose membership comprises 277 of the world's largest commercial, merchant and investment banks. ISDA's members represent a broad cross section of the institutions that act as dealers and end-users of derivatives. ISDA has worked closely with legislative bodies and tax authorities throughout the world to address issues associated with privately-negotiated derivatives transactions, including hedging transactions.

The Proposal would require a taxpayer to recognize taxable gain, but not loss, on the "constructive sale" of appreciated stock, debt instruments or partnership interests. A constructive sale would occur if a hedging transaction "substantially eliminates the taxpayer's risk of loss and opportunity for gain" with respect to the appreciated position.

We respectfully suggest that it would be a serious mistake to enact this constructive sale proposal, for the reasons set forth below. We urge the Administration and Congress to act in a more considered and deliberate manner so that novel changes in the tax law are well considered and do not inadvertently penalize bona fide financial transactions that both the Administration and Congress have previously recognized as important to our economy.

1. The Proposal would make dramatic changes in the tax system without an appropriate period of examination and consideration. One of the most basic principles of our tax system is the realization requirement, which holds that a taxpayer should recognize its gain or loss in a transaction when that gain or loss has been "realized", i.e., turned into to cash or other property. The realization requirement ensures that in our self-policed tax system taxpayers know when they are subject to tax, and that taxation generally occurs when a taxpayer obtains cash to pay the tax.

There are, of course, several exceptions to the realization requirement that have been added to the Internal Revenue Code over time. Those exceptions are, however, relatively few, because the realization requirement has been considered to be an important guide to fairness and administrability in the tax system. Departures from the realization principal have been made only in the most compelling circumstances, and then only in a carefully circumscribed way.

For example, the scope of the mark-to-market rules in Section 1256 and Section 475 are quite precise, and there is relatively little uncertainty about whether those provisions apply to a particular transaction. In each case, before the exception to the realization requirement was enacted, there was exhaustive review by Congress, the staffs of the tax writing committees, experts in the Treasury and the Internal Revenue Service and taxpayers who would be affected.

By contrast, the Proposal would, if enacted, impose a partial mark-to-market regime for gains in certain hedging transactions without the benefit of review and debate about the need for a departure from the realization requirement or the scope of that departure. It appears that news accounts of a particular transaction have triggered a headlong rush to abandon long-standing tax policy. That rush is having a predictable effect: a legislative proposal has been made that sweeps well past its intended boundaries, and a piecemeal reaction to one reported transaction appears to be taking the place of the comprehensive review of the taxation of financial transactions that the Administration has previously announced.

We suggest that any legislation that would abandon the realization requirement should be aired for widespread review and debate. The Proposal should be the subject of hearings so that interested parties inside and outside of the Government can address it thoughtfully, with full consideration of its intended and unintended consequences. We believe that the enactment of the Proposal without full vetting will seriously undermine taxpayers' confidence in the Code's fairness.

We also suggest that the uncertain scope of the Proposal and its retroactive effective date have chilled taxpayers' ability to engage in important legitimate risk management techniques in fear of retroactive tax consequences. We urge the Administration and Congress to refrain from making disruptive retroactive proposals of novel legislation in the future.

2. <u>There is no need for a "constructive sale" rule for equity swaps and similar transactions.</u> The underlying premise of the Proposal is that a taxpayer who has entered into an equity swap has effectively sold its position and thus should be taxed as if it made an actual sale. This premise is incorrect. In a sale, the taxpayer exchanges its position for cash or other property, which it may then use as it pleases. In an equity swap, the taxpayer does not generate any cash; instead, it agrees by contract to make payments measured by one index in order to receive payments measured by another index, for the term of the contract. The differences are many and are important. Among the most significant are these:

First, in a conventional equity swap the taxpayer does not generate any cash. It is locked into receiving taxable periodic payments based on a specified index for the life of the contract and has no liquidity to change its investment except by negotiating a termination of the contract. Thus, the contract is illiquid, and is not a means to achieve the liquidity available from a sale. Moreover, the Proposal would impose tax on a transaction before that transaction has generated sufficient cash to pay that tax.

Second, in an equity swap the taxpayer retains "counterparty risk", meaning that it will not be paid if the counterparty to the contract defaults. The taxpayer is not fully insulated from market risk on its underlying hedged position. There is no similar risk faced by a taxpayer that sells its position.

Third, the typical equity swap is a temporary arrangement. A sale is a permanent disposition of a position. Equity swaps typically have terms that may be measured in months, and only rarely exceed five years. At the end of the equity swap the taxpayer is in the same posture with respect to the hedged position as it was before the transaction.

Thus, an equity swap is a temporary hedging transaction in which the taxpayer does not achieve the liquidity, the absence of counterparty risk or the permanence of risk transfer that it could achieve in a sale. We therefore believe that entering into an equity swap is not an appropriate occasion for recognizing gain in a position. We do not believe that a convincing case has been made to create an exception to the realization requirement for equity swaps and similar transactions, particularly in the absence of time for full consideration of the merits of the Proposal.

3. <u>The scope of the "substantial elimination of risk" standard is extremely unclear.</u> The Proposal does not achieve its goal of treating as "constructive sales" a specific class of transactions that are perceived to be economically similar to actual sales. A critical question raised by the Proposal is how to identify whether a transaction "substantially eliminates the taxpayer's risk of loss and opportunity for gain" with respect to a position. How closely does the payment index need to track the economics of an underlying position before the opportunity for gain and loss in that position is "substantially eliminated"? Is it sufficient to retain 10% of the upside potential? 15%? 20%? 25%?

Can the tolerances be closer if both upside and downside risk are retained? If a taxpayer enters into a "collar", how tight can it be without triggering a "constructive sale"? (A collar is a combination of a "cap" and a "floor" in which the holder of a hedged position receives a payment to the extent the value of the position falls below the floor, and makes a payment to the extent that the value of the position rises above the cap.)

Is there a constructive sale if the taxpayer retains a significant portion of the upside (or downside) potential, but not the first portion (e.g., the taxpayer retains the benefit of appreciation of between 15% and 30%)? Is risk "substantially eliminated" if the value of the underlying equity makes up only a small part of the relevant index? What if the index does not include the underlying equity, but includes other equities in the same industry?

These are not hypothetical questions. If the Proposal is intended to address situations where the taxpayer has cleanly traded its economic interest in one position for another, that intention is not clear from the text of the Proposal.

4. The Proposal may have many unintended consequences. One predictable effect of enacting a vague standard that overturns a longstanding central tax policy without adequate consideration is that it will have unpredictable consequences. For example, is the Proposal intended to treat a short-term interest rate swap as a "constructive sale" of investment grade debt securities owned by a taxpayer, even if the swap is not intended to hedge those securities? Will entering into a borrowing be treated as a constructive sale of a debt instrument held as an asset, if that new liability effectively insulates the taxpayer from changes in the price of the asset due to interest rate fluctuations?

After a "constructive sale" of a share of stock by a taxpayer, who is taxed on the dividends paid on the stock? When an equity swap terminates, is the taxpayer deemed to purchase the underlying equity for purposes of determining its holding period? For purposes of the wash sale rules? For purposes of Section 338? For purposes of Section 382?

Can a taxpayer with expiring loss carryovers trigger gain to absorb those losses without selling any asset by entering into a short-term equity swap? Can a taxpayer manage its foreign tax credit position by entering into a "constructive sale" of illiquid assets?

This is not meant to be an exhaustive list of issues raised by introducing the notion of a "constructive sale" into the Code. Instead, it is intended to highlight the fact that departing from the fundamental realization requirement opens a host of new questions that need to be answered.

5. Summary. ISDA believes that the realization requirement has been a sound guide to fairness and administrability in our system, and that exceptions to that requirement should be made only after thorough consideration. ISDA is doubtful that a "constructive sale" rule is needed to curb perceived abuses created by the use of equity swaps or similar transactions. If such a rule is considered to be advisable, ISDA urges that it have a clear purpose, that it be drafted in a manner that will achieve that purpose without chilling useful economic activity, and that the ramifications of that rule be fully reviewed. The Proposal in its present form does not do so.

STATEMENT
OF THE
INVESTMENT COMPANY INSTITUTE

ON NEW REVENUE PROVISIONS IN
PRESIDENT CLINTON'S FISCAL YEAR 1997 BUDGET

BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

MAY 15, 1996

The Investment Company Institute (the "Institute") [1] submits for the Committee's consideration the following comments regarding proposals to (1) require sellers of securities to calculate gains and losses using an average cost basis, (2) increase the penalties under section 6721 for failure to file correct information returns, and (3) modify section 1374 of the Internal Revenue Code [2] to require current gain recognition on the conversion of a large C corporation to an S corporation. These proposals are in President Clinton's Fiscal Year 1997 budget, but were not included in the Balanced Budget Act of 1995.

I. Average Cost Basis For Securities

Background

Taxpayers who sell stocks or other securities are allowed to account for the disposition in one of several ways under section 1012 and the regulations thereunder: by specifically identifying the securities sold, or by using the first-in-first-out method. In addition, the regulations under section 1012 provide that dispositions of shares in a regulated investment company ("RIC") may be accounted for using an average cost basis, determined using either the "double-category" or the "single-category" method. [3]

Proposal

The President's Fiscal Year 1997 budget includes a proposal which would require taxpayers to calculate gains and losses on dispositions of substantially identical securities, including shares of a RIC, using an average cost basis determined under the single-category method. For purposes of determining whether gain or loss on a disposition is short-term or long-term, a taxpayer generally would be deemed to dispose of substantially identical securities on a first-in-first-out basis. The proposal would not apply to certain contractual financial products, such as over-the-counter options, and the proposal would give the Treasury Department authority to treat securities that are substantially identical as not subject to the required use of the average cost basis method if the securities have a special status under the Internal Revenue Code (e.g., securities contributed to a partnership with built-in gain). The proposal would apply to securities sold more than 30 days after enactment of the proposal.

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes **5,876 open-end** investment companies ("mutual funds"), **448 closed-end** investment companies and **10 sponsors** of unit investment trusts. Its mutual fund members have assets of about **$2.994** trillion, accounting for approximately 95% of total industry assets, and have **over 38 million individual shareholders.**

[2] All references to "sections" are to sections of the Internal Revenue Code.

[3] The double-category method divides all shares in an account at the time of each disposition into two categories based on whether the shares have been held for the long-term holding period, and permits the taxpayer to specify from which category shares are sold. The single-category method does not divide shares in an account into different categories, but provides that shares are deemed to be sold on a first-in-first-out basis.

. Recommendation

The Institute strongly opposes the average cost basis proposal. The proposal would increase taxes on securities investors, and thus reduce incentives to save and discourage capital investment. Moreover, the proposal would discourage reinvestment in successful companies, but would have no effect on those who purchase a particular type of security only once.

Requiring use of the average cost basis method would complicate, rather than simplify, tax calculations. For example, if a RIC investor purchased shares and reinvested quarterly dividends for ten years, the investor's cost basis for a single share would not be the price paid for that share, but would instead be an average of 41 different purchases occurring over a ten year period. It would not be unusual for an investor's cost basis for a single share to be an average of more than 41 different purchases, because investors often hold shares longer than ten years, and some RICs pay dividends monthly instead of quarterly (an investor purchasing shares and reinvesting monthly dividends for 15 years would calculate the cost basis for a single share as the average of 181 different purchases occurring over the 15 year period).

Complex attribution rules also would be needed to prevent avoidance of the average cost basis requirement through the use of related persons and controlled entities. For example, attribution rules would be required to prevent avoidance by (1) having securities held by the taxpayer's children or other relatives, (2) holding securities in joint accounts, and (3) establishing separate partnerships, trusts and other entities to hold securities. Thus, the average cost basis method of accounting for dispositions of securities would substantially complicate basis calculations for millions of securities investors.

In many circumstances, a securities investor would not be able to rely on a broker or the RIC in which the investor holds shares to perform the average cost basis calculations required by the proposal. In part, this is due to the effective date of the proposal--it would apply to all securities sold more than 30 days after enactment. While RICs often provide average cost basis information to their shareholders, they typically do so only for accounts opened after (or shortly before) the implementation of a system for providing average cost basis information. The provision of average cost basis information to new accounts reflects the fact that the RIC cannot calculate the average cost basis with respect to old accounts from which shares were redeemed prior to the establishment of the system to calculate average cost basis. In addition, in many cases a RIC would not be able to provide average cost basis calculations to investors who acquire shares by gift or inheritance, or to investors who otherwise did not purchase the securities from the RIC seeking to provide the average cost basis calculations. Thus, it cannot be assumed that the necessary average cost basis calculations will in all events be provided to investors.

Finally, the proposal would be retroactive, affecting every investor who purchased securities previously, when specific identification of securities sold was a permissible method to determine basis.

II. Increased Penalties for Failure to File Correct Information Returns

Background

Current law imposes penalties on payers, including RICs, that fail to file with the Internal Revenue Service ("IRS") correct information returns showing, among other things, payments of dividends and gross proceeds to shareholders. Specifically, section 6721 imposes on each payer a penalty of $50 for each return with respect to which a failure occurs, with a maximum penalty of $250,000. [4] The $50 penalty is reduced to $15 per return for any failure that is corrected within 30 days of the required filing date and to $30 per return for any failure corrected by August 1 of the calendar year in which the required filing date occurs.

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[4] Failures attributable to intentional disregard of the filing requirement are generally subject to a $100 per failure penalty that is not eligible for the $250,000 maximum.

Proposal

The President's Fiscal Year 1997 budget contains a proposal which would increase the $50-per-return penalty for failure to file correct information returns to the greater of $50 per return or five percent of the aggregate amount required to be reported correctly but not so reported. The increased penalty would not apply if the total amount reported for the calendar year was at least 97 percent of the amount required to be reported.

Recommendation

The Institute opposes the proposal to increase the penalty for failure to file correct information returns. Information reporting compliance is a matter of significant concern to RICs. A premium is placed on providing the IRS and RIC shareholders with timely, accurate information returns and statements. As a result, a high level of information reporting compliance is maintained within the industry.

The Internal Revenue Code's information reporting penalty structure was comprehensively revised by Congress in 1989 to encourage voluntary compliance. Information reporting penalties are not designed to raise revenues.[5] The current penalty structure provides powerful incentives for RICs to promptly correct any errors made.

III. Conversions of Large C Corporations to S Corporations

Background

Section 1374 generally provides that when a C corporation converts to an S corporation, the S corporation will be subject to corporate level taxation on the net built-in gain on assets held at the time of the conversion if the assets are sold within 10 years. In Notice 88-19, 1988-1 C.B. 486, the 10-year rule for the recognition of built-in gain in section 1374 was extended administratively by the IRS to C corporations that convert to RIC or real estate investment trust ("REIT") status. Notice 88-19 provides that, pursuant to the repeal of the General Utilities doctrine, the IRS intends to promulgate regulations under section 337(d) providing that a C corporation which converts to a RIC or REIT will be treated as if the corporation had sold all of its assets and liquidated, thus requiring the corporation to recognize any net built-in gain on assets held at the time of the conversion. However, Notice 88-19 provides that the regulations will permit the corporation to avoid the immediate recognition of built-in gain if the RIC or REIT elects to be subject to rules similar to section 1374.

Notice 88-19 was supplemented by Notice 88-96, 1988-2 C.B. 420, which states that the regulations to be promulgated under section 337(d) will provide a safe harbor from the recognition of built-in gain in situations in which a RIC fails to qualify under Subchapter M for one taxable year and subsequently requalifies as a RIC. Specifically, Notice 88-96 provides a safe harbor for a corporation that (1) immediately prior to qualifying as a RIC was taxed as a C corporation for not more than one taxable year, and (2) immediately prior to being taxed as a C corporation was taxed as a RIC for at least one taxable year. The safe harbor does not apply to assets acquired by a corporation during the C corporation year in a transaction that results in its basis in the assets being determined by reference to a corporate transferor's basis. Nor does the safe harbor apply to a corporation that has not previously qualified as a RIC.

Proposal

The President's Fiscal Year 1997 budget proposes to repeal section 1374 for large corporations. For this purpose, a corporation is a large corporation if its stock is valued at more than five million dollars at the time of the conversion to an S corporation. Under the proposal, a conversion of a large C corporation to an S corporation would be treated as a liquidation of the C corporation, followed by a contribution of the assets to an S corporation by the corporation's shareholders. Both the converting corporation and its shareholders would recognize gain upon the conversion. The proposal further provides that Notice 88-19 would be revised to provide that the conversion of a large C corporation to a RIC or REIT would result in

[5] In the Conference Report to the 1989 changes, Congress recommended to IRS that they "develop a policy statement emphasizing that civil tax penalties exist for the purpose of encouraging voluntary compliance." H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 661 (1989).

the immediate recognition of the corporation's net built-in gain. Thus, the Notice, if revised as proposed, would no longer permit a large corporation that converts to a RIC or REIT to elect to apply rules similar to the 10-year built-in gain recognition rules of section 1374.

Recommendation

Because the safe harbor set forth in Notice 88-96 is not based upon the 10-year built-in gain rules of section 1374, the repeal of section 1374 for a large C corporation converting to an S corporation should have no affect on Notice 88-96. Instead, the safe harbor is based on the recognition that the imposition of a significant tax burden on a RIC that fails to qualify for a single year would be excessive. Moreover, the imposition of tax would fall directly on the RIC's shareholders, who are typically middle-class investors.

The Institute understands from discussions with the Treasury Department that the proposed revision to section 1374 and the related change to Notice 88-19 are not intended to impact the safe harbor provided by Notice 88-96.

Should the Congress adopt this proposal, the Institute recommends that the legislative history include a statement, such as the following statement, making it clear that the proposed revision to section 1374 and the related change to Notice 88-19 would not impact the safe harbor set forth in Notice 88-96 for RICs that fail to qualify for one taxable year:

> This provision is not intended to affect Notice 88-96, 1988-2 C.B. 420, which provides that regulations to be promulgated under section 337(d) will provide a safe harbor from the built-in gain recognition rules announced in Notice 88-19, 1988-1 C.B. 486, for situations in which a RIC temporarily fails to qualify under Subchapter M. Thus, it is intended that the regulations to be promulgated under section 337(d) will contain the safe harbor described in Notice 88-96.

STATEMENT OF
DR. RICHARD L. BERNAL
AMBASSADOR FROM JAMAICA TO THE UNITED STATES
SUBMITTED TO THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

IN RESPONSE TO ITS REQUEST FOR WRITTEN COMMENTS ON PROVISIONS IN THE PRESIDENT'S FY 1997 BUDGET

MAY 15, 1996

Thank you for allowing me to submit a statement in connection to two provisions that were contained in the President's FY 1997 budget request -- NAFTA parity and the modifications to the Section 936 tax credit.

This statement reviews the twelve years during which US/Caribbean trade has flourished under the Caribbean Basin Initiative (CBI) legislation. In addition, it examines the structure of the US/Jamaican and US/Caribbean trading partnership, assesses the impact of the North American Free Trade Agreement (NAFTA) on US/Caribbean trade flows, and discusses the importance of Caribbean parity legislation before Congress -- The Caribbean Basin Trade Security Act (S. 529, HR 553) -- to rebuild confidence in US/Caribbean economic relations. Finally, this statement will also note Jamaica's concern over attempts to scale back or eliminate the Section 936 tax program, which benefits Jamaica through the Qualified Possession Source Investment Income (QPSII) provision.

I. Overview

In 1996, the Caribbean Basin is faced with two fundamental, yet conflicting trade trends. On one hand, as it stands now, NAFTA has emerged as an immediate challenge to the viability of the US/Caribbean trading relationship. In providing preferential access to a number of Mexican products, which form an important base of the Caribbean export portfolio, NAFTA will cause substantial erosion of the Caribbean competitive position vis-a-vis the US market. On the other hand, NAFTA represents a building block in the establishment of a hemispheric free trade area, a goal that has been enthusiastically endorsed by Jamaica as part of the Free Trade Area of the Americas (FTAA) process.

The Caribbean Basin Trade Security Act (S. 529/HR 553) -- which has attracted widespread bi-partisan support and the backing of the Clinton Administration -- creates a mechanism to address and reconcile these diverging trends. First, the Caribbean Basin Trade Security Act will provide a short term remedy to the trade and investment imbalances caused by NAFTA. Second, this measure will create a transitional framework through which Caribbean countries like Jamaica can attain the long term goal of integration into hemispheric free trade. ***Quick passage and enactment of this important measure, therefore, is vitally important to sustain the US/Caribbean economic and trade partnership.***

II. The Caribbean Basin Initiative at Twelve

In August 1995, the Caribbean Basin Initiative (CBI) marked its 12th anniversary. In the dozen years since it was established, the CBI has emerged as an important stimulus of economic development in the Caribbean Basin and of trade linkages throughout the region. The effect has been felt -- not only in Kingston and Montego Bay -- but also in Miami, Baltimore, New Orleans, New York, and hundreds of other communities throughout the United States. In many ways, the CBI has exceeded the expectations of the drafters of the CBI legislation who wrote in 1990 amendment to the CBI, "The Congress finds that...a stable political and economic climate in the Caribbean region is necessary for the development of the countries in the region and for the security and economic interests of the United States."[1]

Through its combination of trade, investment, and tax policies, the CBI legislation has progressively established a framework that has allowed mutually beneficial US/Caribbean economic links to flourish. In turn, Jamaica and other Caribbean countries have matched the liberalizing reforms enacted by the CBI to launch their own trade and investment economic reform programs. Together, the United States and Caribbean countries have created a trade partnership that now exceeds $24 billion a year.

The successes of the CBI legislation are reflected in the figures signalling robust growth in the US/Caribbean trade partnership. Since the mid-1980's, US overall exports to the Caribbean have expanded by over 100 percent and Caribbean exports to the United States have climbed by more than 50 percent. The Caribbean Basin now comprises the tenth largest market for the United States, and is one of the few regions where the United States consistently posts a trade surplus.

With US exports exceeding $15.3 billion in 1995, US/Caribbean commercial links support more than 300,000 jobs in the United States. During the past decade, more than 18,000 American jobs have been created each year as US trade links with the Caribbean have expanded. Throughout the Caribbean, where the economies are much more dependent upon trade, increased exports to the United States has generated hundreds of thousands of additional jobs. Such employment growth has been felt in both export industries, as well as in the many sectors that cater to these industries.

Such trade and employment growth reveals a fundamental characteristic of US/Caribbean production cycles. The existence of CBI market access agreements, combined with the proximity and skills of the Caribbean workforce, has made Caribbean production an attractive and profitable element of any US production strategy. For example, through offshore assembly agreements, the Jamaican private sector has developed an active partnership with US industry to take advantage of the most efficient productive activities that each country offers. In a host of industries, US and Jamaican firms cooperate to produce finished goods using a combination of Jamaican and American skills, capital, and technology. It is this complementarity of Jamaican/US production that maintains the competitiveness of the final product in the global marketplace and even in the US market.

The new structure of trade means that economic growth and development in the Caribbean now directly translate into expanded export opportunities for the United States. Roughly 70 cents of each dollar Jamaica earns from exports to your country is spent in the United States buying American-made consumer goods, food products, industry inputs, and capital equipment. When compared with each dollar of Asian imports, which only generates about 10 cents worth of subsequent US purchases, trade with the Caribbean becomes an important priority for the United States.

Moreover, by providing a mechanism to enhance US/Caribbean commercial links, the CBI has created a sound basis for cooperation in other areas, such as environmental protection, counter-narcotics activities, the promotion of democracy, and regional security measures.

III. NAFTA and the CBI

A. NAFTA's Preferential Access over the CBI

[1] Section 201 of the Caribbean Basin Economic Recovery Expansion Act of 1990. Codified at [19 USC 2701nt; PL 101-382; Title II]

This established structure of trade in the region, ensures that the impact of NAFTA will be substantial, both in the United States and throughout the Caribbean. In effect, NAFTA alters the successful formula for sound economic development in the Caribbean by granting Mexico access to the US market on terms more favorable than those available for CBI exporters.

While the CBI program provides for duty free treatment for a vast number of products, it statutorily excludes a few items -- such as textiles and apparel, footwear, luggage, watches, tuna, and petroleum -- that are among the Caribbean Basin's most valuable exports. This means that a portion of each CBI country's exports will not enjoy CBI treatment. As much as 40 percent of Jamaica's actual exports are not covered by the duty free treatment scheduled under the CBI or Generalized System of Preferences (GSP) programs. Moreover, some of these products -- such as textiles and apparel and sugar -- also face quota-based trade barriers in addition to these duties.

In contrast, NAFTA eliminates the duty and quota treatment for these same articles, either immediately or over a phase-out period. Under NAFTA, import duties were immediately removed on the overwhelming majority -- approximately 80 percent -- of Mexican apparel exports to the United States. The remaining 20 percent benefits from an accelerated implementation of free trade, with annual duty cuts and quota liberalization set to be completed by the year 2000. To be fair, NAFTA also phases out the duties on the products for which the CBI countries already enjoy duty free treatment.

But the result is far from even. Mexico gains parity with the Caribbean countries for CBI-covered products, establishing a level playing field for those items on which Mexican and Caribbean exporters face no duty. But on the products excluded from the CBI, such as textile and apparel products, Mexico gains access to the US market, exceeding that granted to the Caribbean countries. This tilts the playing field in Mexico's favor, and gives Mexican exporters a distinct advantage over Caribbean exporters. When combined with Mexico's access to cheap energy, lower transport costs, greater economies of scale, and low wage rates, this advantage becomes quite substantial.

NAFTA also grants Mexico an extremely valuable exception to tough textile and apparel "rule-of-origin" requirements -- the so-called tariff preference levels (TPLs) -- to allow for preferential entry into the US market of textile and apparel products that contain fabrics from countries other than Mexico, Canada, and the United States. This provision is intended to provide flexibility for the Mexican garment industry to meet the changing demands of US clothing purchasers. TPLs work through a tariff-rate quota, providing low duty rates each year to non-originating products before applying a high tariff to any amount above quota. In allowing such a price break, NAFTA enables Mexican exporters to lower the average cost of their products while maintaining high volumes to satisfy US importers and retailers.

CBI textile and apparel exporters -- and their customers -- enjoy no such flexibility. Without similar TPL provisions for CBI countries, non-originating Caribbean garment exports -- even if Caribbean parity is enacted -- face the higher tariff rates. This would give Mexico, and even low-cost producers in Asia, a distinct price-advantage in competing in certain product areas. At the same time, Caribbean exporters would lose sales opportunities since the CBI and CBI parity incentives would be to shift production away from items that were not cut and sewn in the United States. Faced with such restrictions, US importers, retailers, and investors, would begin to pass over the Caribbean Basin as a profitable place from which to do business.

B. NAFTA's Effects on the US/Caribbean Partnership

Broadly speaking, NAFTA's implementation -- and advantages over the CBI -- poses four clear risks for the US/CBI partnership. The elimination of quotas and the phase-out of tariffs on Mexican products removes the advantage enjoyed by CBI exports to the US market, ***diverting trade flows***

from CBI countries to Mexico. In the two years since the NAFTA was implemented, there has already been a measurable diversion of trade from the CBI to Mexico. The American Apparel Manufacturer's Association (AAMA) reports that the growth rate of US apparel imports from the CBI region dropped by 60 percent from 1993 to 1994. During that same period, the growth rate of apparel imports from Mexico nearly doubled. Moreover, trade statistics from 1995 indicate that Mexican garment exports to the United States continued to expand at three times the rate of those from CBI countries. As this trend continues, Caribbean countries could witness a broad diversion of American demand from suppliers in CBI countries to firms in Mexico, thus reducing CBI exports and income.[2]

Another consequence of NAFTA's implementation has been the ***diversion of new investment.*** One of the primary indicators has been the fact that in the last 4 years there has been a pause in investment in the region, as investors first waited to evaluate the NAFTA provisions and then established new operating facilities in Mexico, instead of in the Caribbean. This trend, which is now being fully realized, as long been anticipated by the US Government. The United States International Trade Commission's (ITC's) 1992 report entitled, "Potential Effects of a North American Free Trade Agreement on Apparel Investments in CBERA Countries", has concluded that "NAFTA will introduce incentives that will tend to favor apparel investment shifts away from the CBERA countries to Mexico".[3]

As existing investors begin to source their products out of Mexico, others are rushing to ***transfer or close existing productive capacity*** -- particularly in "foot-loose" industries which can easily be relocated -- to take advantage of Mexico's market access. In many Caribbean Basin countries, particularly throughout Central America, NAFTA directly reverses past successes of the CBI program, effectively turning back the clock of Caribbean development.

An erosion of export access to the United States will eventually translate directly into a ***contraction of economic activity in the CBI region.*** Such a contraction would lower regional incomes, and, ultimately, the demand for imports from the United States. In such a scenario, US exports of goods and services to the CBI would decline while ***regional instability -- fostered by a decrease in economic opportunities -- would rise.*** Judging from past patterns, the resulting unemployment in the United States would be met with an increase in immigration from displaced Caribbean workers and a rise in narcotics trafficking.

IV. The Caribbean Basin Trade Security Act as an Immediate Remedy

Although it is difficult to assess the Administration's proposal, since specific legislative language has not yet been released, Congress does have before it a workable proposal to effect parity of market access between Caribbean countries and Mexico. The Caribbean Basin Trade Security Act (S 529/HR 553) very simply will restore a level playing field between Mexico and the Caribbean Basin countries. It will provide for non-discriminatory access into the US market for those products on which NAFTA gives Mexico an unintended advantage.

S. 529/HR 553 builds on the existing CBI program and legislation. It does not establish a new set of criteria by which countries can become eligible for the benefits, but rather links the enhanced benefits to the existing

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[2] See Martin, Larry "Testimony of Larry Martin, American Apparel Manufacturing Association," before the House Ways and Means Subcommittee on Trade on HR 553, the Caribbean Basin Trade Security Act. Serial Report 104-4. p. 93.

[3] See "Potential Effects of a North American Free Trade Agreement on Apparel Investment in CBERA Countries." Report to the United States Trade Representative on Investigation No. 332-321. USITC Publication 2541. July 1992.

program criteria. In this way, S 529/HR 553 recognizes that many Caribbean countries --through trade liberalization and economic reform measures -- have already undertaken steps that exceed the criteria outlined in the original legislation. Moreover, it also ***ensures that additional, valuable time is not lost -- and the US/Caribbean partnership further undermined -- as CBI countries satisfy new "entrance criteria."***

Another important feature of the Caribbean parity bill is that it ***includes all products that are currently excluded by the CBI.*** As our economies liberalize, it becomes increasingly difficult to erect artificial barriers between product categories. Extending parity for only certain textile and apparel products would have a limited effect on the situation that we are trying to address. Enacting a comprehensive parity bill, however, is both economically more feasible and symbolically more consistent with the notion of free and open trade.

In this regard, S. 529/HR 553 includes a welcome provision giving the Administration authority to negotiate tariff preference levels for non-originating textile and apparel products. Such a provision does not compel the use of TPLs, but merely recognizes that -- ***with similar TPLs available for Mexico -- the fairness of a fully level playing field requires the same for the Caribbean.***

Finally, S. 529/HR 553 is a ***cost-effective way for the United States to conduct foreign trade and economic policy in the region***, especially in this era of budget cutbacks. Any losses to the reduction in tariffs should be more than offset by two factors. <u>First</u>, even without Caribbean parity, the United States can expect to lose tariff revenue as trade and investment is diverted to the duty free export platforms in Mexico. Restoring those exports to the Caribbean, by cutting the tariffs faced by imports from the Caribbean, will not represent a new loss of tariff revenue, but merely a recognition of tariff revenue that is already being lost.

<u>Second</u>, a preliminary calculation suggests that the gains of trade liberalization and economic growth should generate alternative sources of revenue for the US Government to offset any tariff revenue losses. The CBI has helped create an average of 16,000 US jobs each year for the past decade. If each of these jobs generates an additional $5,000 in tax revenues during the first year, trade liberalization with the CBI could yield roughly $80 million in new revenues in that year alone. In the second year, as 16,000 additional jobs are created, US revenues will expand by $160 million. Over five years, such figures yield roughly $1.2 billion, exceeding the CBO estimates by several hundred million dollars.

<u>V. The Caribbean Basin Trade Security Act as a Transitional Mechanism for Hemispheric Integration</u>

S 529/HR 553 -- both explicitly and implicitly -- recognizes a greater goal of bringing the Caribbean Basin countries into a hemispheric free trade area. In this regard, S 529/HR 553 furthers the agenda developed at the Miami Summit with one critical difference. While much of the attention has focused on linking the larger economies of South America with that of the NAFTA, ***S 529/HR 553 puts forth a tangible framework to determine how the Caribbean economies will be joined in this free trade arrangement as well.*** It very much recognizes that the spirit of Miami exists in all the countries throughout the Caribbean.

Specifically, S 529/HR 553 provides for a transitional period during which full parity with Mexico will be provided for Caribbean countries. Jamaica supports an appropriate and realistic time frame to provide Caribbean Basin countries an opportunity to complete the trade liberalization and economic reform steps necessary for accession to a free trade agreement with the United States. While some countries -- such as Jamaica -- are now ready to negotiate free trade agreement with the United States, others may need a longer period outlined in the Caribbean parity bills.

A reasonable period will also create ***a viable time frame that will help restore "confidence" in the Caribbean*** that has been eroded as previous plans have been proposed and discarded. As investors and traders see that time period, they will be able to grasp a tangible expression of the US commitment to its trade relationship with CBI countries. One concern, however, is that the time frame not be seen as an excuse to put Caribbean countries -- ***which have established a close trade relationship with the United States and which have already met many of the NAFTA entry requirements -- at the back of the NAFTA accession line.*** Jamaica's hope is that NAFTA accession will include those countries that have made viable strides toward trade liberalization, and not just those representing the largest export markets for US firms.

In addition, in making the period temporary, ***S 529/HR 553 creates a viable incentive for Caribbean countries to complete their reform programs.*** Each Caribbean country will spend the next decade working to enact and implement the measures necessary to ensure smooth negotiation of a free trade agreement with the United States.

The bill ***initiates a dialogue between the Administration and the Caribbean Basin countries on ways to preserve and strengthen the US/Caribbean trading relationship***. Even in the absence of specific trade negotiating authority, such a dialogue is important to help maintain the momentum of the Miami Summit. In addition, the bill requires the Administration to perform a series of studies and reports on the US/Caribbean trade relationship. In a sense, S 529/HR 553 asks the Administration to continually ask the question: "What will be the impact of a specific policy change on the Caribbean." Such a questions should have been asked as NAFTA was considered. This emphasis is appropriate, partly because of the close trade relationship between the United States and the Caribbean. In addition, this focus will help ensure that eventual free trade talks with the Caribbean Basin countries -- which are among the most committed trade liberalizers -- are not delayed by a need to initiate trade talks with the larger economies of the Hemisphere.

VI. Jamaica's Commitment to Trade Liberalization

Jamaica is deeply committed to an open multilateral trading system is a stimulant to economic growth, both through the static gains from increased efficiency in the utilization of its existing resources and the dynamic gains from the opportunities to expand productive capacity through new technology, investment, and innovative entrepreneurship.

Jamaica is an advocate of trade liberalization within the hemisphere and of a multilateral trading system that approaches free trade as far as possible. Jamaica subscribes to, and its policy has always been fully consistent with, the principles and disciplines of the GATT. Jamaica joined the GATT in the early 1960's and has been an active participant in, and has contributed to, successive negotiating rounds aimed at further liberalization of global trade.

Moreover, Jamaica actively participates in several regional trade-liberalization arrangements with the United States (the Caribbean Basin Initiative -- CBI), Europe (the LOME Convention), Canada (CARIBCAN), and the other English speaking countries in the Caribbean (the Caribbean Common Market - CARICOM). All of these arrangements are intended to promote trade between the member countries. Finally, Jamaica also has supported the creation of free trade within the Western Hemisphere using the North American Free Trade Area (NAFTA) as a first building block of free trade within the hemisphere.

Jamaica realizes that there is now a new phase of globalization of production and finance which is rapidly sweeping away national barriers to the movement of goods, services, capital, and finance. During the 1980's, Jamaica's economic policies focused on economic reform, stabilization, and structural adjustment in an attempt to create an environment conducive to a private sector-led, market-driven, outward-looking growth strategy. An important aspect has been a comprehensive program of trade liberalization involving substantially reduced tariffs and the elimination of quantitative trade restrictions. This has been complemented by freeing market forces within the domestic economy through the abolition of price and exchange controls by a vigorously implemented campaign of privatization and fiscal and monetary discipline. A stable, market-determined exchange rate system is operating successfully, preventing any disruptive changes in the value of the Jamaican dollar.

In the last four years there has been a substantial acceleration in the process of liberalizing the trade regime of Jamaica, with an emphasis on the removal of import restrictions and the lowering of tariffs. In many ways, US products in the Jamaican market are accorded better access than Jamaican products in the US market because Jamaica does not rely upon quotas as a tool of trade policy. Jamaican sugar and apparel products, for example, still face US quotas.

This commitment to outward-looking trade and development policies is firmly based on the knowledge that the benefits to be derived are those of higher growth rates and enhanced capacity to adjust to external shocks. Expanding trade contributes to Jamaica's growth by enabling the economy to improve its productivity by specializing in exports in which it has a comparative advantage. Production for the world market allows firms to achieve the economies of scale which are precluded by a small domestic market. Exposure to competition from imports serves to improve cost efficiency and benefits consumers by lower prices.

Jamaica now sees the CBI program as a springboard to greater hemispheric free trade liberalization. In many cases, we have already taken steps that exceed the requirements of the CBI to help accelerate this goal. ***Jamaica has signed a bilateral investment treaty (BIT) and an intellectual property rights (IPR) agreement with the United States. We were also one of the first countries to include new anti-circumvention language in our bilateral textile agreement with the United States.***

Jamaica is ready and has a demonstrated commitment to enter the next stage of trade liberalization with the United States -- that of negotiating a free and reciprocal trade agreement.

VII. Note on Section 936

Jamaica has also followed, with growing concern, Congressional efforts to scale back or eliminate the Section 936 tax program. Any action to dilute this program could dampen Caribbean economic development in a manner analogous to NAFTA's adverse effect on the US/CBI trading relationship.

Although the program initially targets Puerto Rico growth and development, it has been extended to support economic growth and development in the Caribbean as well. Currently, the Section 936 code contains a provision through which investors in Puerto Rico receive an income tax credit on Qualified Possession Source Investment Income (QPSII). Jamaica and several other CBI beneficiaries benefit from this section since the QPSII funds may be used to finance projects in eligible CBI countries.

Jamaica is concerned about the elimination of such a program for several reasons. First, the QPSII program provides a substantial source of private sector funding for Jamaican development programs. Since the mid 1980's, when Jamaica became eligible for the program, Section 936 funds have supported over $500 million worth of investments in development projects, including the privatization of the tourism industry. Because investors earn tax free income on their investment income, they are able to make the funds available for development projects in the Caribbean at relatively low rates. This makes the Section 936 program a particularly attractive and appropriate source of funds for Caribbean countries, who have difficulty raising capital on international markets.

Second, as foreign aid dollars decline, Jamaica is looking increasingly toward private sector sources of financing such as the Section 936 program. If the Section 936 program goes as well, the increased pressures on the private capital markets from all Caribbean countries will drive up interest rates, making future development projects prohibitively expensive. This would undermine the past decade of success with the Section 936 program as well as the entire CBI program.

Third, eligibility of access to CBI funds depends upon successful implementation of a Tax Information Exchange Agreement (TIEA) with the United States. To date, the following countries have signed Tax Information Exchange Agreements: Barbados (1984), Jamaica (1986), Grenada (1987), Dominica (1988), Dominican Republic (1989), Trinidad and Tobago (1990), St. Lucia (1991), Costa Rica (1991), Honduras (1991), and Guyana (1992). At the time these agreements were signed, the understanding was that 936 funds would be available for investments in the Caribbean. Elimination of the Section 936 program calls into question a fundamental US commitment supporting this treaty obligation.

Finally, as little as two years ago, Congress considered and rejected a move to modify the QPSII income tax credit. Dilution of this important program for the Caribbean made little sense in 1993. It makes even less sense now. For many of the same reasons why Caribbean parity legislation should be enacted, Congress should continue to resist efforts to eliminate or dilute the QPSII tax credit in the Section 936 program.

VIII. Conclusion

The CBI has proven to be an unqualified success. It has relied upon tax and trade incentives to foster a strong, and interdependent, economic relationship between the United States and the Caribbean.

The potential for NAFTA to divert trade and investment from the Caribbean is nothing new, and has been discussed extensively since the idea for NAFTA was first raised. The Administration and Congress have long recognized this problem, but have so far been unable to find a satisfactory formula to rectify it. In 1994, the United States came close to enacting a partial fix by considering the Clinton Administration's Interim Trade Program (ITP). Although the ITP was not enacted, it did heighten the awareness of this problem and the need to resolve it quickly. In the search for ways to keep the US/Caribbean partnership healthy and build the framework to make the free trade spirit of Miami a reality, the Caribbean needs a full, transitional mechanism to help it work towards a more compelling free trade objective.

In addition, in order to keep the wheels of free trade lubricated, the Caribbean Basin needs access to capital to help finance investment and trade projects. US official development assistance once played an important role in that respect. But as foreign aid flows are diminishing, the Caribbean Basin will turn increasingly toward private sources of capital like the Section 936 QPSII program.

The Caribbean Basin Trade Security Act (S 529/HR 553) is a well-conceived measure that will help Jamaica and other CBI countries achieve that goal. At the same time, Congress should take care not to hobble that progress by weakening the Section 936 program, a key financing mechanism for the Caribbean.

US/CBI Trade Statistics (1985 - 1995)
(Millions of US Dollars)

Year	US Imports	US Exports	Annual Export Growth	Trade Balance
1985	6687	5942	--	-745
1986	6065	6362	7.1%	297
1987	6039	6906	8.6%	867
1988	6061	7690	11.4%	1629
1989	6637	8290	7.8%	1653
1990	7525	9569	15.4%	2044
1991	8372	10013	4.6%	1641
1992	9627	11263	12.5%	1636
1993	10378	12428	10.3%	2050
1994	11495	13441	8.1%	1946
1995	12673	15306	13.8%	2633

Average Annual U.S. Export Growth: 9.96%

Note: 1995 marked the 10th straight year of U.S. trade surpluses

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Number of US Workers Dependent on
Trade with the Caribbean Basin Nations

Year	Total Number of US Workers*	Number of New U.S. Jobs Created Per Year
1985	118,840	--
1986	127,240	8,400
1987	138,120	10,880
1988	153,800	15,680
1989	165,800	12,000
1990	191,380	25,580
1991	200,260	8,880
1992	225,262	25,002
1993	248,552	23,290
1994	268,814	20,292
1995	306,120	37,306

Average Annual Job Creation: 18,731

* Assuming that $1 billion in US exports creates 20,000 US trade-related jobs.

Source: US Department of Commerce
US International Trade Commission

Updated: April 9, 1996

STATEMENT OF MERRILL LYNCH & CO., INC

Response to Treasury Tax Proposals

These comments respond to several of the tax proposals released by the Treasury Department on December 7, 1995. Merrill Lynch believes that the goal of sound tax policy should be to increase saving and foster productive investment, in order to ensure U.S. economic growth and our continued leadership in the global economy.

While Merrill Lynch applauds the ongoing efforts to balance the federal budget, it is unfortunate that some of the tax changes proposed by the Administration move in exactly the wrong direction. We are seriously concerned about the damage these proposals have caused -- and will continue to cause -- to the capital-raising activities of American business and the investments these companies are making for future growth.

We will limit our comments to the Treasury proposals to deny interest deductions on certain debt instruments, defer original issue discount deduction on convertible debt, and limit the dividends-received deduction. We believe these proposals are anti-investment and anti-capital formation. If accepted by Congress, they would increase the cost of capital for American companies.

We also have serious concerns about the other proposals in the President's budget affecting the securities markets. We endorse the comments submitted to the Committee on these provisions by the Securities Industry Association and the Public Securities Association.

The U.S. enjoys the world's broadest and most dynamic capital markets. They allow businesses to access the capital needed for growth, while providing investment vehicles individuals can rely on to secure their own futures. Our preeminent capital markets have long created a competitive advantage for the U.S., helping our nation play its leading role in the global economy.

Unfortunately, the Administration's proposals would serve to limit the financing alternatives available to businesses, harming both industry and the individuals who invest in these products. We believe this move by the Administration to curtail the creation of new financial alternatives runs directly counter to the long-run interests of our economy and our country.

Merrill Lynch believes that these proposals are ill-advised, for three central reasons:

- **Increase Cost of Capital**. While Treasury officials have stated their tax proposals will primarily impact the financial sector, this is simply not so. In reality, the burden will fall on issuers of these securities -- that is, American business. Treasury's proposals would force companies to abandon efficient and cost-effective means of financing now available and turn to higher-cost alternatives, which will limit productive investment.

- **Disrupt Capital Markets**. Sudden and capricious tax law changes have a chilling effect on business investment and capital formation. Indeed, the Treasury proposals have already caused a significant disruption in capital-raising activities, causing companies to reevaluate their plans. Furthermore, this disruption has been magnified by the fact that Treasury announced its proposal as retroactive, without providing transition rules or an opportunity for companies to explore other financing alternatives.

- **Fail to Generate Promised Revenue**. The Treasury's proposals are unlikely to raise the promised revenue, and could even lose revenue. Treasury's revenue estimates appear to assume that the elimination of the tax advantage of certain forms of debt would cause companies to issue equity instead. To the contrary, most companies would likely move to other forms of debt issuance -- ones that carry higher coupons and therefore involve higher interest deductions for the issuer.

Merrill Lynch also has deep concerns about the manner in which the Administration introduced its proposals. These provisions are significant changes and have already had a major impact in the capital markets. Nevertheless, the Administration chose to propose them without consultation with industry or financial market participants, without a single congressional hearing, and without sufficient time for careful review. We believe it would be a serious mistake to move forward on proposals of this magnitude without extensive hearings and full consideration.

It is also unfortunate that the Treasury has chosen to characterize these proposals as "loophole closers" that would eliminate "abusive transactions." The fact is, the tax regulations at issue here have been carefully reviewed -- some for decades -- by Treasury and IRS officials, and have been deemed to be sound tax policy. Far from being "abusive," transactions based on these regulations are undertaken by a wide range of the most innovative and respected manufacturing and service companies in the U.S. economy, who collectively employ millions of American workers.

At a time when the private sector and the federal government should together be pursuing ways to strengthen the U.S. economy, these proposals would weaken it by disrupting capital raising activities across the country. Merrill Lynch strongly urges the Administration and Congress to set aside these proposals. Looking forward, we would be delighted to participate in full and open discussions on these proposals, so that their ramifications can be explored in depth.

The following are detailed responses and reaction to the three Treasury proposals that would directly affect capital-raising and investment activities in the U.S.

I. Proposal to Defer OID Deduction on Convertible Debt

The Treasury's proposal to defer or eliminate deductions for original issue discount ("OID") on Original Issue Discount Convertible Debentures ("OIDCDs") ignores established authority, is based on demonstrably false assumptions about market behavior and offers reasons for change which are inconsistent with clearly observable facts. This proposal also disregards regulations adopted after nearly a decade of careful study by the Treasury and the Internal Revenue Service. Consequently, Treasury's proposal would hastily reverse the results of years of careful study. In addition, the proposed elimination of deductions for OID paid in stock is at odds with the tax law's general treatment of expenses paid in stock.

In a poorly reasoned attempt to draw a distinction between OIDCDs and traditional convertible debt Treasury misstates current law with regard to the deduction of accrued but unpaid interest on traditional convertible debentures.

Finally, the proposal would destroy the symmetry between issuers and holders of debt with OID. This symmetry has been the pillar of tax policy regarding OID. The Treasury offers no rationale for repealing this principle.

While billed as a revenue raiser, it is also clear that adoption of the Treasury's proposal would in fact reduce tax revenue.

TREASURY'S PROPOSAL IGNORES ESTABLISHED AUTHORITY, IS BASED ON DEMONSTRABLY FALSE ASSUMPTIONS ABOUT MARKET BEHAVIOR AND OFFERS REASONS FOR CHANGE WHICH ARE INCONSISTENT WITH CLEARLY OBSERVABLE FACT.

The Treasury's December 7, 1995 proposal to, among other matters, defer OID deductions on convertible debt offers the following as its stated "Reason for Change".

> **"Reason for Change**
>
> The line between debt and equity is uncertain, and it has proved difficult to formulate general rules to classify an instrument as debt or equity for all purposes or to bifurcate an instrument into its debt and equity components. While the IRS has taken the position that some purportedly debt instruments with substantial equity features should be treated as equity, other instruments have not been specifically addressed. Taxpayers have exploited this lack of guidance by, among other things, issuing instruments that have substantial equity features (including many non-tax benefits of equity), but as to which they claim interest deductions. In many cases, these instruments have been issued in exchange for outstanding preferred stock."

It is critical to recognize that not one sentence in Treasury's stated "Reason for Change" applies to OIDCDs.

First, the IRS has formally reviewed all the issues concerning OIDCDs and issued a private letter ruling confirming that the issuer of such securities may deduct OID as it accrues. PLTR 9211047, December 18, 1991. Obviously issuers of OIDCDs have not "exploited this lack of guidance" from the IRS and quite the contrary have relied on official IRS guidance in the form of a private letter ruling. That the IRS issued a ruling on this topic confirms that OIDCDs do not exploit any ambiguity between debt and equity. Obviously, if any such ambiguity existed the IRS would not have issued its ruling.

Second, there is no uncertainty regarding OIDCDs' status as debt. These securities are booked on the issuers' balance sheets as debt and are treated as debt by the credit rating agencies. Therefore, issuers receive no "non tax benefits of equity".

Third, we are aware of no exchange of OIDCDs for outstanding preferred stock.

The Treasury's proposal goes on to state that it applies to:

> "Certain debt instrument that are convertible at the holder's option when it is substantially certain that the right will be exercised. Thus, the proposal would not affect typical convertible debt."

In this segment of Treasury's proposal specifically addressed to OIDCD securities, Treasury sets forth yet another "Reason for Change":

> **"Reason for Change**
>
> In many cases, the issuance of convertible debt with OID is viewed by market participants as a de facto purchase of equity."

The above two statements combine to evidence the fact that Treasury's proposal is based on demonstrably false assumptions about real world market behavior. Treasury makes clear that its proposal would not affect "typical" convertible debt on the grounds that the "typical" convertible debentures are not certain to convert. Since OIDCDs have been available in the market place in substantial volume for over ten years, it is possible to compare the conversion experience of so-called "typical" convertible debentures with the conversion experience of OIDCDs, nearly all of which has been zero coupon convertible debt. The data shows that "typical" convertible debentures are much more likely to convert to equity, that is, to be paid off in stock, than zero coupon convertible debentures.

An analysis of all 85 zero coupon convertible debt securities sold in the public debt markets between 1985 and 1995 shows that forty-seven of those issues have already been retired. */ Of those 47, only 14 were finally paid in stock. The other 33 were paid in cash. The remaining 38 of the 85 issues were still outstanding in December 1995. If those 38 securities would have been called in December 1995, only nine of them would have converted to stock and the other 29 would have been paid in cash. In other words, the conversion features of only 9 of the 38 issues remaining outstanding were "in the money". Overall, only 27% of the 85 public offerings of zero coupon convertible debt securities have been (or would be if called in December 1995) paid in stock. Thus in only 27% of the issuances has the conversion feature ultimately controlled.

However, an analysis of all 555 domestic issues of "typical" convertible debt retired from 1985 to 1995 shows just the opposite results. Seventy-nine percent (79%) of these offerings converted into the issuer's common stock. Treasury's statement that "the proposal would not affect typical convertible debt" because of the uncertainty of conversion is completely inconsistent with the historical data.

The Treasury's proposal is clearly without logic. It makes no sense to say that an instrument that has a 27% probability of converting into common stock is "viewed by market participants as a de facto purchase of equity," and therefore the deduction for OID on that instrument should be deferred, while an instrument that has a 79% probability of conversion should be treated for tax purposes as debt. **/ All zero coupon convertible debentures are treated as debt on the issuer's

*/ Data supporting the points made in this paper is available upon request.

**/ Given this data, even if one accepted the Treasury's assertion that probability of conversion in some way governed appropriate tax treatment, the proposal obviously addresses the wrong convertible security.

balance sheet and are treated as debt by the rating agencies. In addition, zero coupon convertible debentures are typically sold to risk averse investors who seek the downside protection afforded by the debentures. Thus, both issuers and investors treat convertible bonds with original issue discount as debt, not equity. The Treasury's offered "Reason for Change" is simply false. We understand that Treasury did not have these facts available to it when it made these proposals.

TREASURY'S PROPOSAL IS AN ARBITRARY ATTEMPT TO REVERSE TAX POLICIES WHICH WERE ADOPTED AFTER NEARLY A DECADE OF CAREFUL STUDY.

The manner in which this legislative proposal was offered is a significant reason to doubt the wisdom of enacting a rule to defer or deny deductions for OID on convertible debentures. When the Treasury issued proposed regulations interpreting the 1982 Act and 1984 Act changes in the Code regarding OID discount, the Treasury asked for comments from the public regarding whether special treatment was necessary for convertible debentures. 51 Federal Register 12022 (April 18, 1986). This issue was studied by the Internal Revenue Service and the Treasury through the Reagan, Bush and Clinton administrations. Comments from the public were studied and hearings were held by the current administration on February 16, 1993. When the Treasury Department of the current administration adopted final OID regulations in January of 1994, the final regulations did not exclude convertible debentures from the general OID rules. After nearly nine years of study under three administrations and after opportunity for public comment, the Treasury decided that it was not appropriate to provide special treatment for OID on the convertible debentures. We suggest that it is not wise policy to reverse, in the heat of budget negotiations and without opportunity for hearings or study, a tax policy which the Treasury had adopted after nearly a decade of study.

TREASURY'S PROPOSAL IS INCONSISTENT WITH THE FUNDAMENTAL PRINCIPLE THAT PAYMENT IN STOCK IS EQUIVALENT TO PAYMENT IN CASH.

As discussed above, the current law is clear that an issuer of a convertible debenture with OID is allowed to deduct that OID as it accrues. The Service's private letter ruling confirms this result. We would now like to focus not on the timing of the deduction but on the portion of the Treasury proposal that would deny the issuer a deduction for accrued OID if ultimately paid in stock. The proposal is inconsistent with the general policy of the tax law which treats a payment in stock the same as a payment in cash. A corporation which issues stock to purchase an asset gets a basis in that asset equal to the fair market value of the stock issued. There is no difference between stock and cash. A corporation which issues stock to pay compensation, rent, interest or any other deductible item may take a deduction for the item paid just as if it had paid in cash.

More precisely on point, the 1982 Tax Act added section 108(e)(10) to the Code to repeal case law which allowed a corporate issuer to escape cancellation of indebtedness income if the issuer retired corporate debt with stock worth less than the principal amount of the corporate debt being retired. The policy of that change was to make a payment with stock equivalent to a payment with cash. Section 108(e)(10) clearly defines the tax result of retiring debt for stock. As long as

the market value on the stock issued exceeds the amortized value of the debt retired, there is no cancellation of indebtedness income. The Treasury's proposal to treat payment of accrued OID on convertible debt differently if the payment is made with stock rather than cash is inconsistent with the fundamental rule that payment with stock is the same as payment with cash. The Treasury's proposal would create an inconsistency without any reason for that inconsistency.

TREASURY'S PROPOSAL MISSTATES CURRENT LAW.

We point out that Treasury's statement of "Current Law" misstates the law regarding interest which is accrued but unpaid at the time of conversion. The Treasury suggests that the law regarding "typical" convertible debt is different from the law for convertible debt with OID. This is clearly not the case. The statutory OID rules have since 1982 required daily accrual of interest income and deductions. Case law from the pre-daily accrual era established that whether interest, or OID, which is accrued but unpaid at the time an instrument converts is an allowable deduction depends on the wording of the indenture. In Bethlehem Steel Corporation v. United States, 434 F.2d 1357 (Ct. Cl. 1971), the Court of Claims interpreted the indenture setting forth the terms of convertible bonds and ruled that the borrower did not owe interest if the bond converted between interest payment dates. The Court merely interpreted the indenture language and concluded that no deduction for accrued but unpaid interest was allowed because no interest was owing pursuant to the indenture. The Court stated that if the indenture had provided that interest was accrued and owing, and that part of the stock issued on conversion paid that accrued interest, a deduction would have been allowed. Since the indentures controlling all of the public issues of zero coupon convertible debt were written to comply with the Bethlehem Steel opinion, the indentures for all of these offerings provide that, if the debentures convert, part of the stock issued on conversion is issued in consideration for accrued but unpaid OID. Thus, there is no tax law principle which requires a difference between "typical" convertible bonds and zero coupon convertible debentures on this point. The only difference is a matter of indenture provisions.

TREASURY'S PROPOSAL OBLITERATES THE LONG ESTABLISHED PRINCIPLE OF TAX SYMMETRY BETWEEN ISSUERS AND HOLDERS OF DEBT WITH ORIGINAL ISSUE DISCOUNT.

The Treasury's proposal reverses the policy of symmetry between issuers and holders. Since 1969, when the tax law first addressed the treatment of OID, the fundamental policy of the tax law has been that holders should report OID income at the same time that the issuer takes a deduction. The Treasury's proposal obliterates this symmetry for convertible debt with OID. Not only would the holders report taxable income before the issuer takes a deduction, but if the debt is converted, the holders would have already reported OID income and the issuer would never have taken an offsetting deduction. The Treasury does not offer any justification for this unfairness.

TREASURY'S PROPOSAL REGARDING ORIGINAL ISSUE DISCOUNT CONVERTIBLE DEBENTURES WOULD REDUCE TAX REVENUE.

While billed as a revenue raiser, adoption of Treasury's proposal with respect to OIDCDs would in fact reduce tax revenue for the following reasons:

- Issuers of OIDCDs view them as a debt security with an increasing strike price option imbedded to achieve a lower interest rate. This a priori view is supported by the historical analysis of OIDCDs which indicates that over 70% have been, or if called at December 12, 1985 would have been, paid off in cash as debt.

- If OIDCDs were no longer economically viable, issuers would issue straight debt.

- Straight debt rates are typically 200 to 300 basis points higher than comparable rates. Therefore, issuers' interest deductions would be significantly greater.

- According to the Federal Reserve Board data, at June 30, 1995 over 60% of straight corporate debt is held by tax deferred accounts versus less than 30% of OIDCDs held by such accounts.

Consequently, if OIDCDs are not viable, issuers will issue straight debt with higher interest rates being deducted by issuers and paid to a significantly less taxed holder base. Treasury's proposal would therefore reduce tax revenue while at the same time interfering with the efficient operation of the capital markets.

Giving full consideration to the above data, much of which we understand Treasury did not have at its disposal at the time it prepared its proposal, we believe rejection of the proposal with respect to OIDCDs is warranted and the reason for doing so compelling.

II. Proposal to Deny Interest Deduction on Certain Debt Instruments

Debt with Maturity Over 40 Years

The Treasury Department has proposed to deny interest deductibility on any debt obligation with a maturity over 40 years. Merrill Lynch believes this is bad tax policy. With regard to any financial instrument, it is wrong to base the deductibility of interest on an arbitrary maturity limit. Instead, deductibility should be based on whether the instrument possesses the following five critical attributes of debt:

- A reasonable maturity date.
- The right to receive a sum certain in cash upon maturity of the instrument.
- The right to receive periodic payments of interest.
- The right to enforce payment of principal and interest in the event of a default.
- A claim on the issuer's assets that is senior to all classes of equity of the issuer and at least *pari passu* with the issuer's general unsecured creditors.

On all but the first of these attributes, it is immediately obvious that debt obligations with maturities over 40 years enjoy exactly the same features as other debt instruments. On the remaining attribute -- a reasonable maturity date -- it has been well established that a debt obligation with a maturity over 40 years will be deemed to possess a "reasonable maturity date" if the issuer's business is expected to continue for the period the obligation remains outstanding.

In addition, recent public offerings of debt obligations with maturities greater than 40 years were priced to provide investors with a debt return, not an equity return. The fact that investors were willing to purchase such obligations *priced as debt* concretely shows that investors view these instruments as possessing the characteristics of debt -- including the attribute of a reasonable maturity date.

Finally, if this Treasury proposal were adopted, Merrill Lynch believes most issuers would simply shift to long-term debt with a maturity under 40 years -- not to equity. This seems to be contrary to the assumptions which underlie Treasury's "scoring" of this proposal. Given that issuers would respond to this proposal by continuing to issue debt -- and therefore deduct coupon payments -- we believe it is unlikely that there will be an increase in revenue to the U.S. Treasury resulting from this proposal.

Deny Deductibility on Other Debt Obligations

Treasury has also proposed to deny interest deductibility on obligations with a maturity greater than 20 years, which are not shown as indebtedness on the issuer's balance sheet. This proposal appears to be aimed at eliminating the interest deductibility of innovative new financial instruments, such as Monthly Income Preferred Securities (MIPS) and Trust-Originated Preferred Securities (TOPrS).

Merrill Lynch believes that a careful analysis of these instruments reveals that they possess *all* of the critical attributes of debt listed above. Indeed, Treasury's proposal does not rely on any of these attributes to curtail the interest deductibility of these instruments. Rather, Treasury has focused on the fact that MIPS, TOPrS, and similar products are not typically shown as debt on a company's balance sheet. The reality is, balance-sheet treatment of these instruments has never before been relevant to their tax treatment and whether they are identified as debt obligations for tax purposes.

TOPrS are a case in point. A company utilizing these instruments issues debt obligations to a trust which, in turn, issues trust securities (i.e., TOPrS) to investors. The transaction is structured in this way to improve the attractiveness of the securities to the public. Because these debt obligations are issued through a trust, TOPrS are not shown on the issuers' balance sheet as debt, although the status of the obligations as indebtedness is clearly disclosed in a footnote to the company's balance sheet.

The balance-sheet characterization of TOPrS -- or MIPS -- as a non-debt *liability* does not alter the conclusion that the underlying debt securities possess all the critical attributes of debt. This is clearly illustrated by the facts that:

- Investors in these instruments are the legal owners of an undivided interest in the underlying debt obligations, and they enjoy all the legal rights and economic benefits as if they had purchased the debt obligations directly from the issuer rather than certificates from the trust.
- Issuers of these securities -- despite their ability to extend an interest payment period for up to five years -- have an absolute obligation to pay interest and principal at maturity.

Merrill Lynch firmly believes that MIPS, TOPrS, and similar instruments are debt obligations, not equity, and they should be taxed as such.

Contrary to Treasury's revenue projections, we also believe this proposal will fail to raise revenue. Issuers that are impacted by the proposed legislation will either choose to issue MIPS- or TOPrS-like securities with a maturity of 20 years or less, or they will maintain the 20+ year maturity of the instruments and issue them directly to investors, rather than through a partnership or trust. Either way, Treasury's proposal will ultimately fail to reduce the amount of interest issuers deduct, and it will therefore be unlikely to raise tax revenue.

Conclusion

With regard to both of these Treasury proposals, it is crucial to recognize that no other major industrialized country has adopted such restrictive and arbitrary limitations on interest deductibility. Our global competitors instead look to the rights of a holder of an instrument under corporate law to determine its categorization for tax purposes. If enacted, the Treasury proposal would restrict financial flexibility of U.S. corporations. Ironically, under this proposal, foreign issuers would be allowed to access the U.S. capital markets with instruments (such as long-dated or perpetual debt) far more desirable to both issuers and investors -- exploiting the vacuum created in part by this Treasury proposal.

III. Proposal to Reduce Dividends-Received Deduction and Modify DRD Holding Period

The Treasury Department has proposed to reduce the dividends-received deduction (DRD) from 70% to 50% on inter-company dividends where ownership is less than 20% of outstanding shares, and also to modify the DRD holding period.

It has long been recognized that the "double taxation" of dividends under the U.S. tax system tends to limit saving, investment, and growth in our economy. The DRD was designed to mitigate this multiple taxation, by excluding some dividends from taxation at the corporate level.

Unfortunately, Treasury's proposal to reduce the DRD would significantly undermine this policy. In the process, it would further increase the cost of equity capital and negatively affect capital formation. Indeed, Treasury's proposal would boost the effective tax rate on inter-corporate dividends by 67%. Ultimately, the burden of the resultant triple taxation will be borne by the individual investor at a maximum effective overall tax rate of 67.6%.

From an economic standpoint, Merrill Lynch believes this would have two distinct negative impacts:

- **Dampen Economic Growth**. If the DRD reduction were enacted, issuers would react to the potentially higher cost of capital by: lowering capital expenditures, reducing working capital, moving capital raising and employment offshore, and otherwise slowing investments in future growth. In particular, American banks, which are dependent on the preferred stock market to raise regulatory core capital will see a significant increase in their cost of capital and, hence, may slow their business-loan generation efforts.

- **Limit Competitiveness of U.S. Business**. The reduction in the DRD would also further disadvantage U.S. corporations in raising equity vis-à-vis our foreign competitors, especially in the UK, France, and Germany. In these countries, governments have adopted a single level of corporate taxation as a goal, and inter-corporate dividends are largely or completely tax free. As long as American firms compete in the global economy under the weight of a double- or triple-taxation regime, they will remain at a distinct competitive disadvantage.

Treasury has also proposed a modification of the DRD holding period -- a change which Merrill Lynch believes would impair trading-market liquidity. Currently, investors have to be "at risk" (i.e., unhedged) for 46 days on their equity portfolio securities to qualify for the DRD. Given the volatility of the equity markets, the risk inherent in a 46-day holding period is already significant. The Treasury proposal to have a "rolling" holding period prior to every dividend payment date is unwarranted and will cause disruption for dealers attempting to provide liquidity in the equity markets.

While the overall revenue impact of Treasury's DRD proposal may be positive, Merrill Lynch believes the revenue gains will not be nearly as large as projected, due to anticipated changes in the behavior of preferred-stock issuers and investors.

- **Issuers of Preferred Stock.** Reducing the DRD will increase the cost of preferred-stock financing and cause U.S. corporations to issue debt instead of preferred stock because of interest deductibility. This overall increase in deductible interest would result in a net revenue loss to Treasury.

- **Secondary Market for Preferred Stock.** Currently, the market for outstanding preferred stock is divided into two segments:

  (1) A $15 billion to $20 billion variable-rate preferred stock market where dividends are set via Dutch auctions. The dividend rate on these securities will necessarily increase to adjust for the lower DRD, and may cause some of these issuers to call these preferred securities at par and replace them with debt. This will result in a revenue loss to Treasury.

  (2) A $45 billion to $55 billion fixed-rate preferred stock market where the issuing corporations cannot immediately call the securities. Retail investors, who comprise 80% of this market cannot utilize the DRD and therefore pay full taxes on dividends. Hence, there will be no meaningful revenue gains to Treasury from this market segment.

This Treasury proposal may also create losses for individual investors. Institutions, which own approximately 20% of all fixed-rate preferred stock, may sell their holdings given the increased taxation. In fact, market prices for fixed-rate preferred stock have already dropped in reaction to the announcement of the Treasury proposal. Individual investors will bear the brunt of any price decline, since they currently account for about 80% of the fixed-rate preferred market. These capital losses, when taken, will offset any capital gains and result in revenue loss to Treasury.

At a time when U.S. tax policy should be moving toward fewer instances of "double taxation," Merrill Lynch believes it would be a mistake to reduce the DRD and make "*triple* taxation" even more pronounced in, and burdensome on, our economy.

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May 15, 1996

Mr. Philip D. Mosely
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Mosely:

This letter contains a summary of the position of my client, the National Association of Convenience Store's ("NACS"), covering the revenue provision of the President's 1997 Budget Proposal. NACS has a significant interest in two of the President's revenue proposals: extension of the tax imposed to fund for the Leaking Underground Storage Trust Fund ("LUST") and extension of the Targeted Jobs Tax Credit ("TJTC"). NACS opposes the extension of the LUST fund tax unless the funds collected are spent on enforcement of the 1998 tank upgrade deadline, clean up reimbursements, and program improvements as set forth in H.R. 3391, introduced by Rep. Dan Schaefer (R-CO) on May 2, 1996. NACS supports the extension of the TJTC, which is included in the President's proposals, provided concerns about the credit's effectiveness are addressed.

NACS is a national trade association with over 1700 member companies in all 50 states. These member companies operate approximately 70,000 convenience stores in the United States, employing over 500,000 workers. NACS retail members that operate retail petroleum outlets and have upgraded their tanks to comply with the 1998 deadline have spent approximately $75,000 per outlet on the upgrade, which does not include the cost of remediation of any leaks discovered.

NACS opposes extension of the LUST tax unless the funds will be truly dedicated to the purposes for which they are collected. NACS is concerned that LUST Trust Fund monies will be used to assist owners of underground tanks to avoid the 1998 deadline for replacement of tanks. Such assistance could take the form of direct loans, low interest loans, or loan guaranties for upgrades after the 1998 deadline.

The 1998 deadline should not be extended for anyone. Owners of underground tanks who went to the expense of upgrading their tanks before the deadline should not be forced to compete with tank owners who did not and are then rewarded with an extension and subsidized replacement. The deadline will have been known for 10 years when it is reached. Anyone who is unable to meet the deadline in 10 years should not be permitted to operate.

NACS would support the extension of the tax if the funds were actually appropriated to the states to (1) supplement tank assurance funds; (2) enforce existing regulatory requirements; and (3) clean up releases beyond the current statutory period. H.R. 3391 would authorize such uses. LUST Trust Fund appropriations dropped to $45 million in 1996 from $70 million in 1995. With approximately $1 billion in trust fund, Congress should appropriate these monies for these purposes.

NACS supports the extension of the TJTC because it benefits workers and it rewards employers who make the extra effort to employ individuals who, for a variety of reasons, would be overlooked. This incentive is good for employees, it is good for employers and it is good for society as a whole. Providing basic work skills to someone who has been "structurally unemployed" is crucial in the long term for the U.S. economy. Furthermore, several studies have shown that the TJTC does, in fact, create jobs. While specific numbers are difficult to pin down, even small growth in job opportunities for low-skilled workers is important in our economy.

Many who qualify for TJTC need that extra help to get access to employment opportunities. To some extent, it is expected that workers with little or no skills will necessarily try a number of jobs until the right match is made. By working in a convenience store, these workers can learn essential job skills that will help them boost their income either within the industry or in other positions where their skills can be utilized. Very basic skills such as coming to work on schedule, personal hygiene, and customer courtesy must be learned. Other skills such as operating a cash register can be transferable as well. In addition, the convenience store industry has a strong history of promotion from within and rewarding good workers with managerial positions.

Critics of the program have often cited the costs associated with TJTC. Yet, the net cost per TJTC certification are significantly lower than the gross tax credit claimed. Three studies have estimated the reductions in transfer payments that result from these hires, along with any additional tax payments to the U.S. Treasury substantially reduces the cost per hire. While long term benefits from job training are harder to quantify, this criticism is a typical example of "penny wise-pound foolish" economics. Furthermore, many NACS members are not using the credits to reduce their tax liability because of the AMT, which further reduces the cost to the Treasury, while not substantially affecting participation by these companies.

The TJTC program has experienced a rather complicated procedure for reauthorization over the years. Three disruptions in the program have resulted in declining participation levels and some target population penetration rates have suffered as a result of these uncertainties. In addition, the 22-24 age group was an important category for NACS members. Because many convenience stores sell alcoholic beverages, they often must have employees who are at least 21 years old. Restoration of this age group would be helpful to the industry.

NACS recognizes the Administration's concerns with the effectiveness of the program. NACS is looking forward to working the the Administration and the Congress on the permanent extension of the TJTC.

NACS appreciates this opportunity to comment on the President's 1997 Budget Proposals. NACS looks forward to working with the Committee on Ways and Means on these and other tax measures during the coming months.

Sincerely,

J. Keith Ausbrook

J. KEITH AUSBROOK
Counsel to the
National Association of Convenience Stores

Comments
of
The National Association of Independent Insurers
on
Revenue Provisions of the President's 1997 Budget Proposal
to the
House Committee on Ways and Means

April 26, 1996

The National Association of Independent Insurers (NAII) is a trade association representing 565 property and casualty insurance companies domiciled in 46 states and transacting business in all 50 states. The NAII was founded 50 years ago on the principles of open competition and pricing flexibility in the insurance industry. Our members range in size from the very largest national writers to the smallest one state writers. They write over $63 billion in direct premiums for all types of property-casualty insurance, including auto first party personal injury protection, auto liability, workers compensation, general and other liability, and property insurance lines. Among our members are mutual and stock companies, reciprocal exchanges, and Lloyds plan affiliates, as well as excess and surplus lines companies that write on a non-admitted basis. Their marketing strategies range from providing the widest range of insurance products to those specializing in a relatively few product lines. They use virtually every kind of product distribution channel, including independent agents, captive agents and direct marketing. The NAII membership is literally a cross-section of the U.S. property-casualty insurance industry.

On behalf of our members companies we respectfully submit the following comments on the revenue provisions of the President's 1997 budget. At the request of the committee these comments are limited to provisions of the budget proposal which were not included in the Balanced Budget Reconciliation Act of 1995.[1] The NAII is also opposed to several provisions of the 1995 reconciliation bill which are included in the President's budget.

Dividends Received Deduction

Current law provides corporations with a deduction equal to 70 percent of the dividends they receive from corporations in which they own less than 20 percent of the stock by vote and value.[2] The dividends received deduction is designed to mitigate the double and triple taxation on corporate earnings. The President proposes to reduce the dividends received deduction available to 50 percent. NAII strongly opposes such a reduction.

The property-casualty insurance industry invests its assets primarily in bonds and securities. A far higher proportion of the assets of property and casualty insurers are held in these investments than are held by nonfinancial corporations. In 1994, 11.3 percent of the property-casualty industry's $704.6 billion assets were held in marketable securities; $10.8 billion in preferred stocks and $70.3 billion in common stock.[3] Reducing the dividends received deduction would result in a 66.7 percent tax increase on these investments, severely impacting insurers and policyholders.

A reduction in the dividends received deduction raises the effective tax rate on dividends, raising the cost of capital and further disadvantaging U.S. equity investment. Market experts estimate that reducing the deduction from 70 to 50 percent would result in price declines of one and one half to seven percent for preferred stocks.[4] For industries, such as property-casualty insurance, this increased tax expense will significantly depreciate the market value of their portfolios. As a result, property-casualty insurance premiums could likely increase. Alternatively, reduced portfolio values would result in a corresponding decrease in surplus, thus impairing the capacity of the U.S. insurance industry to support existing and new business.

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1 H.R. 2517
2 Internal Revenue Code § 243
3 Best's Aggregates and Averages - Property-Casualty, A.M. Best Company, 1995, p. 2
4 Flaherty and Crumrine, Inc., Dec. 1995

It can be argued that even the current taxation of dividends is a contentious tax area because it represents a punitive system that taxes the same income multiple times. In addition to its punitive nature, the current system also places U.S. investment at a distinct disadvantage. Many of our trading partners have a 100 percent dividends received deduction, thus providing international competitors with an advantage in raising capital in the U.S. market. The President's proposal would also exacerbate these problems.

Extension of Interest Deduction Disallowance

Current law disallows a deduction for interest on debt incurred or continues to purchase or carry tax-exempt bonds.[5] In general, a deduction is disallowed only when indebtedness is directly related to tax-exempt obligations. Taxpayers may establish the purpose of the interest either by direct or circumstantial evidence. Direct evidence exists when the proceeds of indebtedness are directly traceable to the purchase of tax-exempt obligations or when the tax-exempt instruments are used as collateral. In the absence of direct evidence, a deduction is disallowed only when the totality of the facts and circumstances establishes a sufficiently direct relationship between the tax-exempt instruments and the indebtedness.[6] Financial institutions, however, are subject to allocation of their interest expense. Interest deductions for financial institutions are disallowed in the same proportion as the average basis of their tax-exempt obligations bear to the average basis of all their assets.[7]

The President's proposal would extend the financial institutions rule to all taxpayers, except insurance companies and other corporations in the cases of nonsalable tax-exempt debt received from state and local governments in payment for goods and services. NAII opposes extension of the pro-rata interest disallowance to non-financial institution taxpayers and the application of the rule to consolidated groups. If the proposal is adopted we urge the Committee to follow the President's proposal to exempt the insurance industry.

Property-casualty insurers already are penalized by proration, which requires the inclusion of at least a portion of tax-exempt interest in their regular tax base and in their alternative minimum tax base under the adjusted current earnings rule. Extension of the pro-rata disallowance to insurers would eliminate practically any remaining incentive for a property-casualty insurer to invest in tax-exempt bonds. The property-casualty insurance industry currently invests considerable sums in state and local tax-exempt bonds. Although mutually beneficial, these investments represent a positive, socially responsible, investment practice. Extension of the disallowance rules to the insurance industry would severely diminish this valuable source of funding for state and local governments at the very time when Congress seeks to move more responsibilities the state and local level. Further, the application of the rule to consolidated groups is an unfair and punitive treatment of substantially independent entities, especially, insurance entities.

Penalty for Failure to File Correct Information Returns

Businesses are required by law to file an informational report with the Internal Revenue Service for each service provider to whom it makes payments which in aggregate total $600 or more per year.[8] These reports must include the name, address and taxpayer identification number of the service provider, as well as the amount of the payments.

Under current, law taxpayers who fail to timely file correct information returns, such as a Form 1099, are subject to a penalty of up to $50 per return, up to $250,000 during any calendar year. Maximum penalties for companies with average taxable incomes of less than $5 million for the previous three years are reduced to $100,000.[9] President Clinton proposes to increase the penalty for failure to file information returns to the greater of $50 per return or five percent of the amount required to be reported. The yearly maximum penalties would remain the same. In cases where

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5 Internal Revenue Code § 265
6 Rev.Proc. 72-18, 1972-1 C.B. 740
7 Internal Revenue Code § 265
8 Internal Revenue Code § 6041 and 6041A
9 Internal Revenue Code § 6723

businesses correctly report in aggregate 97 percent of the aggregate amount required to be reported, the penalty would remain $50 per return. NAII opposes this provision.

The additional reporting requirement will be particularly burdensome and costly for property-casualty insurers. Property-casualty companies make tens of millions of payments each year on behalf of policyholders to third-party service providers, such as auto repair shops, towing services, construction companies, doctors, and hospitals. Typically, the insurer has no role in selecting the service provider or control over the information provided by the third-party. Insurance personnel generally do not contract with the service provider. In fact, some states prohibit insurers from requiring claimants to utilize a specific service provider. The first notice the insurer has of the arrangement is often the receipt of an invoice from the service provider. Such arrangements make it extremely difficult for insurers to obtain timely and accurate taxpayer information. Nevertheless, the President's proposal would punish an insurer for an inaccurate report that occurs through no fault of its own.

The provision would also be particularly onerous for property-casualty insurers who face extensive state requirements to assure timely payment of claims. The Unfair Claim Practice Laws of most states require that insurers attempt in good faith to make prompt payment of insurance claims. Individual states often impose specific payment deadlines, such as California which requires that payments for auto repairs be made within 10 days from the receipt of the invoice.[10] Several states, including Florida, Kentucky and Louisiana , impose penalties or interest on insurers if payments are not made within specified time periods following a proof of loss.[11] Insurance companies face the almost insurmountable task of acquiring information from third-parties with which they often have no contractual arrangement in a very compressed period of time. The President's proposal would unfairly penalize property-casualty insurers for errors which they did not intend and cannot avoid.

Net Operating Loss Carryback

Taxpayers are permitted under current law to carryback a net operating loss (NOL) for three years and carryforward for 15 years.[12] The President proposes to reduce the carryback period for NOLs arising in tax years beginning after 1995 to one year and extend the carryforward period to 20 years. NAII strongly opposes this proposal.

The NOL carryback enables taxpayers to spread the effects of losses and to properly reflect the effects of activities on taxable income. The ability to spread the effects of loss is particularly important for the property-casualty industry. Property-casualty insurers often experience losses which are directly related to activities in prior taxable years. Claims, particularly liability, relating to coverage written and premiums collected in a taxable year are often not paid until several years later. The NOL carryback provision allows property-casualty companies to more accurately reflect income and spread the effect of such losses to profitable years.

In recent years, the property-casualty industry has suffered enormous catastrophic losses. In terms of inflation-adjusted losses, seven of the eight most severe U.S. catastrophes have occurred since 1989. In fact, the industry experienced over $67 billion in catastrophic losses from 1989-1995—more than 50 percent greater than the losses of the entire 1980's.[13] The catastrophic losses of the past seven years represent approximately 30 percent of the industry's collective surplus, and the industry is examining many alternatives to try to deal with this issue. The likelihood of more devastating losses in the future is very real—increasing the potential for significant loss periods. There is a 25 percent chance that the property-casualty industry could experience losses exceeding $10 billion in any given year and a 20 percent chance that single year catastrophic losses could top $50 billion during any ten-year period.[14]

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10 California Insurance Code § 560

11 Florida Insurance Code § 627.4265
Kentucky Insurance Code § 304.12-235
Louisiana Insurance Code § 22:658

12 Internal Revenue Code § 172(b)(1)(A) & (B)

13 Lighting Candles in the Wind, Conning & Co., Hartford, 1994, p. 29

14 Catastrophe Risk: A National Analysis of Earthquake, Fire Following Earthquake, and Hurricane Losses to the Insurance Industry, Risk Management Solutions, Inc. and ISO, 1995, p.8

A reduction in the NOL carryback period would hamper the ability of the industry to respond to such disasters by eliminating a significant mechanism for capital restoration. The recovery of taxes previously paid and the ability to spread tax liability to profitable years allow the industry to weather catastrophic losses by providing a needed infusion of capital and spreading of risk. The President's proposal would threaten the capacity of insurers to support existing and new businesses, reduce availability, and drive up the cost of insurance products.

Superfund Excise Tax and Corporate Environmental Income Tax

The Superfund program was created by Congress is 1980 to ensure cleanup of America's most hazardous waste sites. Prior to January 1, 1996, the Superfund Trust Fund was supported by imposition of a 9.7 cent per barrel excise tax on domestic and imported crude and refined products, an excise tax ranging from 22 cents to $4.87 per ton on certain hazardous chemicals, and an excise tax on imported substances which use any of the taxed substances in their manufacture or production.[15] In addition, corporations were subject to a .12 percent tax on the amount of modified alternative taxable income exceeding $1 million.[16] The President proposes to reinstate the three excise taxes effective with enactment of the legislation and to reinstate the corporate environmental income tax for taxable years beginning after December 31, 1995.

In the last 15 years billions of tax dollars have been collected and spent on Superfund cleanup, yet very little progress has been made in ridding the nation of toxic waste. Currently, nearly half of every Superfund dollar goes toward bureaucratic overhead and for legal expenses to settle disputes between the Environmental Protection Agency and Potentially Responsible Parties (PRPs) at a given site, between PRPs and their insurance companies, and between PRPs and others brought into Superfund litigation through third-party lawsuits.

As NAII supports meaningful reform of the Superfund law, we believe extension of the Superfund excise tax and the corporate environmental income tax should be a part of that reform.

NAII, therefore, recommends that these proposals in the President's budget proposal not be adopted.

Respectfully submitted,

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[15] Internal Revenue Code §§ 4611, 4661, 4671
[16] Internal Revenue Code § 59A

Comments of the

National Association of Real Estate Investment Trusts®

to the

Committee on Ways and Means
U.S. House of Representatives

regarding certain

Revenue Provisions in the President's

Fiscal Year 1997 Budget

Submitted by Stanford J. Alexander, NAREIT Chair and
Chairman and Chief Executive Officer, Weingarten Realty Investors

May 15, 1996

As requested in Press Release No. FC-15 (April 15, 1996), the National Association of Real Estate Investment Trusts® ("NAREIT") respectfully submits these comments in connection with the Ways and Means Committee's review of certain revenue provisions presented to the Ways and Means Committee as part of the President's Fiscal Year 1997 Budget. NAREIT's comments will address the Administration's proposal to amend section 1374 of the Internal Revenue Code to treat an "S" election by a large C corporation as a taxable liquidation of that C corporation. We appreciate the opportunity to present these comments.

NAREIT represents over 270 real estate investment trusts (known as "REITs"), over 220 of which trade on the New York Stock Exchange, the American Stock Exchange, or the National Market System of the NASDAQ. In addition, NAREIT represents over 1,600 analysts, investment bankers, lawyers, accountants, and others that provide services related to the REIT industry.

Congress established REITs in 1960 to allow small investors to obtain the diversification and professional management of capital-intensive real estate that beforehand were only available to large, sophisticated investors.[1] The market capitalization of publicly traded REITs has blossomed from under $9 billion at the beginning of 1991 to about $70 billion today, as hundreds of thousands of small investors assisted in the recapitalization of portions of America's premier commercial real estate properties.

This growth in the use of the public equity market as a source of funds for real estate has played a critical role in solidifying the foundation of many quality real estate operating companies, as well as improving the assets of banks, insurance companies and pension plans. It also has resulted in an opportunity for achieving Congress' goal of providing small investors with the opportunity to become owners of those properties along with the best real estate managers in the country.

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[1] Congress ensured that REITs operate in that manner by instituting various ownership tests comparable to those applied in the identification of a personal-holding company. See I.R.C. sections 856(a)(5) and (a)(6).

I. APPLICATION OF SECTION 1374 TO REITs

As the Committee knows, prior to its repeal as part of the Tax Reform Act of 1986, the holding in an old court case named General Utilities permitted a C corporation to elect S corporation or REIT status (or transfer assets to an S corporation or REIT in a carryover basis transaction) without incurring a corporate-level tax. With the repeal of the General Utilities doctrine, such transactions arguably would have been subject to tax but for Congress' enactment of section 1374. Under section 1374, a C corporation making an S corporation election can elect to have the S corporation pay any tax that otherwise would have been due on the "built-in gain" of the C corporation's assets, but only if those assets were sold or otherwise disposed of during a 10-year "recognition period." The application of the tax upon the disposition of the assets, as opposed to the election of S status, worked to distinguish legitimate conversions to S status from those made for purposes of tax avoidance.

In Notice 88-19,1988-1 C.B. 486 (the "Notice"), the Internal Revenue Service (the "IRS") announced that it intended to issue regulations under section 337(d)(1) that in part would address the avoidance of the repeal of General Utilities through the use of REITs and RICs. In addition, the IRS noted that those regulations would permit the REIT to be subject to rules similar to the principles of section 1374. Thus, under regulations that have to yet been issued, C corporations would have the ability to elect REIT status and incur a corporate-level tax only if the REIT sells assets during the "recognition period."

In a release issued February 22, 1996, the Department of the Treasury (the "Treasury Department") announced that it intends to revise Notice 88-19 to conform to the Administration's proposed amendment to limit section 1374 to corporations worth less than $5 million, with an effective date similar to the statutory proposal. This proposal would result in a double layer of tax: once to the shareholders of the C corporation in a deemed liquidation and again to the C corporation itself upon such deemed liquidation.

Because of the Treasury Department's intent to extend the proposed amendment of section 1374 to REITs, the remainder of these comments addresses the proposed amendment as if it applied to both S corporations and REITs.

II. ARGUMENTS IN SUPPORT OF THE CURRENT APPLICATION OF SECTION 1374 TO REITS

As stated above, the Administration's proposed amendment would limit use of the 10-year election to REITs valued at less than $5 million. NAREIT believes that this proposed amendment would contravene Congress' original intent regarding the formation of REITs, would be both inappropriate and unnecessary in light of the statutory requirements governing REITs, would impede the recapitalization of commercial real estate, likely would result in lower tax revenues, and ignores the basic distinction between REITs and partnerships.

A fundamental reason for a continuation of the current rules regarding a C corporation's decision to elect REIT status is that the primary rationale for the creation of REITs was to permit small investors to make investments in real estate without incurring an entity level tax, and thereby placing those persons in a comparable position to larger investors. H.R. Rep. No. 2020, 86th Cong., 2d. Sess. (1960).

By placing a toll charge on a C corporation's REIT election, the proposed amendment would directly contravene this congressional intent, as C corporations with low tax bases in assets (and therefore a potential for a large built-in gains tax) would be practically precluded from making a REIT election. As previously noted, the purpose of the 10-year election was to continue to allow C corporations to make S corporation and REIT elections when those elections were supported by non-tax business reasons (e.g., access to the public capital markets), while protecting the Treasury from the use of such entities for tax avoidance.

Additionally, REITs, unlike S corporations, have several characteristics that support a continuation of the current section 1374 principles. First, there are statutory requirements that make REITs long-term holders of real estate. The REIT "thirty-percent gross income test"[2] and prohibited transactions tax[3] are direct compliments to the 10-year election mechanism.

Second, while S corporations may have no more than 35 shareholders, a REIT faces no statutory limit on the number of shareholders it may have, are required to have at least 100 shareholders, and in fact some REITs have hundreds of thousands of beneficial shareholders. NAREIT believes that the large number of shareholders in a REIT and management's responsibility to each of those shareholders preclude the use of a REIT as a vehicle to be used primarily in the circumvention of the repeal of General Utilities. Any attempt to benefit a small number of investors in a C corporation through the conversion of that corporation to a REIT is impeded by the REIT widely-held ownership requirements.

In addition, REIT management has a legal and fiduciary responsibility to determine the timing and reasons for the disposition or distribution of the entity's assets with the intention of benefiting all shareholders. Thus, there is no tax avoidance if a REIT sells assets in the first 10 years, but rather only a deferral.

The consequence of this proposal would be to preclude C corporations in the business of managing and operating income-producing real estate from accessing the substantial capital markets infrastructure comprised of investment banking specialists, analysts, and investors that has been established for REITs. In addition, other C corporations that are not primarily in the business of operating commercial real estate would be precluded from recognizing the value of those assets by placing them in a professionally managed REIT. And in both such scenarios, the hundreds of thousands of shareholders owning REIT stock would be denied the opportunity to become owners of quality commercial real estate assets.

Furthermore, the $5 million dollar threshold that would limit the use of the current principles of section 1374 is unreasonable for REITs. While many S corporations are small or engaged in businesses that require minimal capitalization, REITs as owners of commercial real estate have significant capital requirements. As previously mentioned, it was Congress' recognition of the significant capital required to acquire and operate commercial real estate that led to the creation of the REIT as a vehicle for small investors to become owner's of such properties. The capital intensive nature of REIT's makes the $5 million threshold essential meaningless for REITs.

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[2] Section 856(c)(4).
[3] Section 857(b)(6).

It should be noted that this proposed amendment is unlikely to raise any substantial revenue with respect to REITs, and may in fact result in a loss of revenues. Because of the high cost that would be associated with making a REIT election if this amendment were to be enacted, it is unlikely that any C corporations would make the election and incur the associated double level of tax without the benefit of any cash to pay the taxes. In addition, by remaining C corporations, those entities would not be subject to the REIT requirement that they make a taxable distribution of 95% of their income each tax year. While the REIT is a single-level of tax vehicle, it does result in a level of tax on nearly all of the REIT's income each year.

Last but far from least, the Administration justifies its de facto repeal of section 1374 by stating that "[t]he tax treatment of the conversion of a C corporation to an S corporation generally should be consistent with the treatment of its conversion to a partnership." Regardless of whether this stated reason for change is justifiable for S corporations, in any event it should not apply to REITs because of the differences between REITs and partnerships.

Unlike partnerships, REIT cannot (and have never been able) to pass through losses to its investors. Further, REITs can and do pay corporate level income and excise taxes. Simply put, REITs are C corporations. Thus, REITs indirectly are less susceptible to the tax avoidance concerns raised by the 1986 repeal of the General Utilities doctrine.

III. SUMMARY

The 10-year recognition period of section 1374 currently requires a REIT to pay a corporate-level tax on assets acquired from a C corporation with a built-in gain, if those assets are disposed of within a 10-year period. Combined with the statutory requirements that a REIT be a long-term holder of assets and be widely-held, current law assures that the REIT is not a vehicle for tax avoidance. The proposal would frustrate Congress' intent to allow the REIT to permit small investors to benefit from the capital-intensive real estate industry in a tax efficient manner.

Accordingly, NAREIT believes that tax policy considerations are better served if the Administration's section 1374 proposal is not enacted as it applies to REITs. If you would like to discuss this in greater detail, feel free to contact Tony M. Edwards, NAREIT's Vice President and General Counsel, at (202) 785-8717.

National
Council of
State
Housing
Agencies

May 15, 1996

Mr. Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Phil:

The National Council of State Housing Agencies (NCSHA) appreciates this opportunity to comment on the new revenue provisions in the President's fiscal year 1997 budget.

NCSHA is a national, nonprofit organization created in 1970 to assist its members in advancing the interests of lower income and underserved people through the financing, development, and preservation of affordable housing. NCSHA's members are Housing Finance Agencies (HFAs) with statewide authority. NCSHA members operate in every state and the District of Columbia, Puerto Rico, and the United States Virgin Islands.

At the center of HFA activities within the states and NCSHA's work in Washington are three federally authorized programs: authority for states to issue tax-exempt Mortgage Revenue Bonds (MRBs) and multifamily housing bonds; the Low Income Housing Tax Credit (Housing Credit); and the HOME Investment Partnerships (HOME) program. NCSHA is the principal advocate for MRBs, multifamily housing bonds, and the Housing Credit, and the principal state advocate for the HOME program.

Using these tools, HFAs have crafted hundreds of housing programs -- from homeownership to rental to all types of special needs housing. Many HFAs also administer other state and federal housing assistance programs.

State HFAs have provided more than 2 million lower income families the help necessary to buy their first home through the MRB program. MRB mortgages typically go to families earning much less and buying homes costing much less than congressionally-imposed MRB program limits.

Average MRB homebuyers make only about 77 percent of the national median income, just 70 percent of an average conventionally financed first-time buyer's income and 60 percent of an average conventional buyer's. Average MRB-financed homes cost only 68 percent of average conventionally financed first-time homes and 54 percent of all average conventionally financed homes.

The states have used multifamily housing bonds to make possible nearly three quarter of a million affordable apartments for low income families. In 1994 alone, the states issued more than $2 billion in multifamily housing bonds to finance almost 35,000 affordable apartments.

444 North Capitol Street, NW, Suite 438 Washington, DC 20001 (202)624-7710 FAX (202)624-5899

We strongly oppose the President's proposal to extend pro-rata disallowance of tax-exempt interest expense to all corporations. This proposal would repeal the "two percent rule," which provides an essential "safe harbor" to corporations which hold tax-exempt bonds by sparing them the burden of tracing all the cash flows within the corporation.

Denied this safe harbor, many corporations simply will not find it practical to invest at all in municipal bonds, including MRBs and multifamily housing bonds. Reduced demand will increase borrowing costs for municipal bond issuers such as HFAs. The bottom line is that first-time homebuyers and low income renters will pay the difference--or be shut out of the market completely--as higher borrowing costs for HFAs translate into higher interest rates on bond-backed mortgages.

The proposal's chilling effect on corporate investment in municipal bonds was vividly illustrated last winter, when the Federal National Mortgage Association (Fannie Mae), a significant investor in municipal housing bonds, was forced to curtail its investment in MRBs almost immediately after the Administration called for an immediately effective repeal of the two percent rule. Other corporations followed suit. Fannie Mae only returned to the market after Ways and Means Committee Chairman Archer wrote Representative English that he intended to fully resist a two percent rule repeal in any balanced budget agreement.

We urge the Chairman and the members of this Committee to continue their strong stand against the Administration's proposal to repeal the two percent rule.

Sincerely,

Barbara Thompson

Barbara J. Thompson
Director of Policy and
Government Affairs

STATEMENT OF THE NATIONAL MINING ASSOCIATION

TO THE COMMITTEE ON WAYS AND MEANS OF THE

U.S. HOUSE OF REPRESENTATIVES

ON THE ADMINISTRATION'S

FISCAL 1997 TAX PROPOSALS

MAY 15, 1996

The National Mining Association (NMA) appreciates the opportunity to submit this statement for the Committee's record on the President's fiscal 1997 tax package. The NMA is an industry association representing most of the Nation's producers of coal, metals, industrial and agricultural minerals. Our membership also includes equipment manufacturing firms and other providers of goods and services to the mining industry.

Mining employs some 300,000 workers directly and supports 3 million jobs in allied industries. Processed material of mineral origin such as coal, copper, gold, zinc and silver total $360 billion, or about 5 percent of the U.S. gross domestic product. The headquarters of operations of NMA member companies are located in 42 states--represented in Congress by 397 members of the House and 84 Senators. Some form of mining represented by the NMA occurs in all 50 states.

Of primary concern to our industry is the proposal in the Administration's budget to repeal the percentage depletion allowance for minerals mined on lands where mining rights were originally acquired under the Mining Law. Simply stated, we are adamantly opposed to this proposal. It is a major tax increase on companies that have mines located primarily in the western United States. As it is not uncommon for ownership of mineral deposits to change hands, the proposal would especially penalize mining companies who purchased their properties from original claimants or other intermediary mining concerns.

From our perspective, the President's depletion proposal has more to do with mining on public lands in the western states than it does with tax policy. The NMA and its member companies continue to support responsible amendments to the Mining Law, including a reasonable royalty provision. This reform effort has been stymied at every turn by anti-mining groups. Those opposing responsible Mining Law amendment seek changes that would make mining on public lands nearly impossible. The Administration's proposal to increase the tax burden on hardrock mines would appear to be a coordinated effort to accomplish that goal.

Increasing the tax burden on the mining industry is effectively an increase in production costs. Because minerals are commodities traded in the international marketplace at prices determined by world-wide supply and demand factors, mining companies cannot recover higher costs by raising prices. Most mines affected by this proposal will see their tax burden increase by as much as 8 percent to 10 percent.

This tax increase is likely to have the following short- and long-term disruptive effects on the industry:

- Force the early closing of marginally economic mines. Minerals that would otherwise have been economic to extract will remain in the ground and not be recovered, resulting in poor stewardship of our natural resources. Existing jobs, federal, state and local tax revenues will be lost.

♦ Higher taxes will reduce the ability of companies to make the necessary investment in existing operations to improve production efficiencies and comply with new environmental, health, safety and pollution control laws and regulations.

♦ Investment in new projects will suffer. This change to long-standing tax policy will adversely affect the economics of new projects. Many new projects will become uneconomic, resulting in lost opportunities for new jobs and tax revenues.

The long-term consequences of tax increases are serious. Without continuous investment in new domestic projects to replace old mines, production in the United States will decline. As the country's demand for mined products continues to grow the short-fall between demand and domestic production will be satisfied by imports of minerals mined by foreign workers. Our exports will be jobs.

The purpose of the depletion allowance is to help foster mining investment. For over 60 years Congress has recognized that because the major asset of a mining company depletes over time a different method of capital recovery is needed. The mining industry is characterized by relative rarity of commercially viable mineral deposits, high economic risks, geologic unknowns, extreme costs and long lead times for developing new mines. For a variety of reasons, even without inflation, the costs of replacing a mineral deposit are generally far greater that the cost of the deposit currently being mined. The depletion allowance is a reasonable and practical method of addressing the unique needs of the extractive industries.

The capital needs of the mining industry are enormous. It is not uncommon to spend in excess of $400 million to bring a domestic world-scale mine into production and to invest a substantial amount on state-of-the-art processing facilities (a new smelter can have capital costs of nearly $1 billion).

The mining industry (and other capital-intensive industries) already pay high effective tax rates through the application of the corporate alternative minimum tax (AMT). The General Accounting Office in a 1995 study reported that the average tax rate for mining under the AMT is 32 percent. As the Ways and Means Committee is well aware, the AMT gives the United States the worst capital cost recovery system in the industrialized world.

The President's proposal will **increase** the tax burden on mining at a time when many noted economists and analysts agree that the tax burden on capital-intensive industries should be **reduced** by reform or outright repeal of the AMT. NMA supported previous efforts of the Committee to accomplish this goal and continues to support substantive reform of the AMT.

The U.S. Department of Labor reports that the mining industry provides some of the highest paying non-supervisory jobs in the United States. The average mining wage in 1994 was $43,653 (not including benefits and overtime pay)--far above the nation-wide average wage of $26,940. We believe that tax policy should foster the creation of more of these high-paying jobs. Unfortunately, the Administration's proposal does just the opposite.

We urge the Committee and the Congress to reject this job-killing tax increase on the mining industry and pass legislation to foster investment and economic growth in mining and other capital intensive industries.

NATIONAL RETAIL FEDERATION

May 15, 1996

The Honorable Bill Archer
Chairman
Ways and Means Committee
U.S. House of Representatives
Washington, D.C. 20510

Dear Chairman Archer:

On behalf of the National Retail Federation (NRF), it is my pleasure to respond to your request for comments on revenue provisions in the President's Fiscal Year 1997 Budget. The NRF is the world's largest retail trade association with membership that includes the leading department, specialty, discount, mass merchandise and independent stores, as well as 33 national and 50 state associations. NRF members represent an industry that encompasses over 1.4 million U.S. retail establishments, employs more than 20 million people, 1 in 5 American workers, and registered 1995 sales of $2.3 trillion. There are two provisions in the President's Budget that strike at the heart of retailing and would be very damaging to our job creating industry.

First, and most importantly, the **retail industry is unanimously opposed to repealing the "lower of cost or market" (LCM) inventory accounting method** included in the President's FY 97 Budget. This proposal, unfortunately, is not a new one. It was first proposed as one of the revenue raisers for GATT and has been on the Administration's list ever since.

The LCM method of accounting has been part of our tax laws since 1917 and is consistent with Generally Accepted Accounting Principles (GAAP). <u>This is not a corporate loophole</u>, but a well-established accounting method. Using LCM, the value of inventories that are unsalable at normal prices are reduced to reflect the fact that the market value of the goods has permanently dropped below their cost.

LCM allows retailers to write down the value of their inventories at the time the value of the goods drop -- rather than when the item is eventually sold. Without LCM, the value "on the books" of retail inventory could be significantly overstated compared to the actual value of the goods "on the shelves".

The World's Largest Retail Trade Association
◆
Liberty Place, 325 7th Street NW, Suite 1000
Washington, DC 20004
202.783.7971 Fax: 202.737.2849

Why are the prices reduced? Either because a newer product has been introduced (i.e., computers or software), the goods are damaged or the product was seasonal and has been permanently put on sale (i.e., winter jackets). Once a product's price is *permanently* marked down, retailers are never able to sell the product -- like a rose bush at the end of the summer growing season -- for more.

If LCM were repealed as the Administration has proposed, retailers whose inventory value has been drastically and permanently reduced, would not be able to deduct the lost value until the goods are finally sold or they are determined to be worthless -- which could be months, even years. Therefore, retailers who are suffering because their goods are worth less would also be socked with higher taxes. Many taxpayers, especially smaller retailers, would be forced to keep two sets of books -- one for accounting and the other for taxes. Retailers would also be forced to change the nature of their business. Repealing LCM will push premature bulk sales of inventories from retailers to liquidators and consolidators -- which could cause this provision to actually lose federal revenue. It will also encourage retailers on FIFO (first in first out) to switch to LIFO (last in first out), a deductible expense, reducing or eliminating any projected revenue pick-up.

Second, NRF urges the Congress not to distort **the treatment of grace period interest** also included in the President's FY 97 Budget. This provision would require retailers who issue credit cards to pay tax on grace period interest before having a fixed right to the income. The proposal would require credit card issuers to include in taxable income an estimate of the amount of grace period interest that will accrue in the future. This estimate would be based on the credit card issuer's assumptions of the likelihood that its credit card customers will not pay their entire balance before the end of the applicable grace period -- which could be highly inaccurate.

Interest on debt instruments (including credit card receivables) is currently accrued under the historic "all events test" whereby taxpayers pay federal income tax on taxable income determined by reducing fixed and determinable income by fixed and determinable expenses. Accrual method taxpayers are not entitled to deduct estimates of future expense (such as bad debts) which, based on experience, are highly likely to be incurred. Prediction of uncertain future events, which the Administration's proposal advocates, have long been rejected as a basis for tax accounting on both the income and the expense side.

Under no circumstances should either of these two proposed changes be viewed as closing a "loophole" or as eliminating "corporate welfare." On the contrary, adopting these proposals can only be viewed as a tax increase and an arbitrary departure from well established tax policy to raise short-term revenue for the federal coffers at the expense of the retail industry and one in five American workers.

Thank you for your careful consideration of these important issues for retailers. We look forward to working with you.

Sincerely,

John

John J. Motley III
Senior Vice President
Government and Public Affairs

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Sheila C. Bair
Senior Vice President
Government Relations

NYSE
New York
Stock Exchange, Inc.

May 6, 1996

The Honorable Bill Archer Chairman Ways & Means Committee U.S. House of Representatives 1236 Longworth House Office Bldg. Washington, D.C. 20515-4307	The Honorable William V. Roth, Jr. Chairman Senate Finance Committee U.S. Senate 104 Hart Senate Office Bldg. Washington, D.C. 20510-0801
The Honorable Sam M. Gibbons U.S. House of Representatives 2204 Rayburn House Office Bldg. Washington, D.C. 20515-0911	The Honorable Daniel P. Moynihan U.S. Senate 464 Russell Senate Office Bldg. Washington, D.C. 20510-3201

Gentlemen:

I am writing to express The New York Stock Exchange's (NYSE) strong views on two proposals included in Title IX of the Administration's Fiscal Year 1997 Budget Proposals, released March 19, 1996.

Average Cost Basis Proposal

The NYSE is strongly opposed to the proposal that would require the use of an average cost basis for purposes of determining gain or loss on the sale or other disposition of securities. The average cost basis proposal would reduce the after-tax return on an investment in securities, discouraging new investment, inhibiting job growth and impeding economic expansion. Moreover, the transition to using average cost basis would result in downward pressure on securities markets as investors accelerate sales of securities prior to the effective date of the proposal.

Under current law, investors may specifically identify securities to be sold. Investors who do not specifically identify securities to be sold must use the first-in-first-out method of accounting to determine the adjusted basis. Under the average cost basis proposal, investors would be required to determine gain or loss on the sale or other disposition of securities using an average cost basis of all substantially identical securities held at the time of disposition. If investors sell less than all of the substantially identical securities, the investors would be treated as having disposed of the securities first acquired for purposes of determining the holding period of the securities sold and of the remaining securities.

The average cost basis proposal effectively increases the capital gains tax by accelerating gain recognition in the case of a sale of less than all of an investor's substantially identical securities having different adjusted bases. This is contrary to the Administration's stated goals of increasing savings[1] and promoting economic growth[2]. Continued economic expansion and the resulting creation of jobs depends in part on the availability of low-cost capital. By reducing the after-tax return on investments in securities, the average cost basis proposal would tend to discourage savings and increase the cost of capital, thus limiting new investment in plants, equipment and technology. In addition, to the extent investors continue to hold existing securities to avoid the increased tax exposure created by this proposal, the average cost basis proposal restricts the efficient flow of capital to its highest and best use, which also will inhibit economic growth. Moreover, we note that middle-income investors will be hardest hit by this proposal because it is these investors who will not be able to avoid selling securities in order to pay for certain expenses, such as college tuition.

Because the average cost basis proposal increases the tax burden on capital gains, it is likely that investors will accelerate sales of securities after enactment of the proposal and before its effective date. In its current form, the average cost basis proposal would apply to sales of securities beginning 30 days after the date of its enactment. We believe that this effective date provision could create substantial downward pressure on securities markets.

In light of the foregoing, we strongly encourage you not to include provisions such as those embodied in the average cost basis proposal in any budget or tax legislation. In the event you decide to include the average cost basis proposal or similar measures -- and the NYSE strongly urges that you do not -- to reduce the downward pressure on securities markets, we ask that the average cost basis proposal apply only to securities acquired on or after the date of enactment.

Constructive Sale Proposal

The NYSE is concerned about the proposal that would require a taxpayer to recognize gain (but not loss) upon entering into a constructive sale of an appreciated position in either stock, a debt instrument or a partnership interest. This provision is overly broad and would not only address abusive transactions but also would discourage legitimate risk management transactions.

We applaud the Administration's desire to combat abusive transactions such as those which are structured to permit a taxpayer to avoid permanently the realization of capital gains on an appreciated stock or debt instrument position in order to permit a stepped-up basis on the taxpayer's death. However, many legitimate risk management transactions also would be covered by the

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[1]*See, e.g.*, Letter from Robert E. Rubin to Rep. Michael N. Castle, 96 TNT 57-66, March 13, 1996, *available in* LEXIS, Fedtax Library, TNT File (stating that the President's Fiscal Year 1997 Budget, submitted February 5, 1996, balances the budget with sufficient savings for modest tax cuts that, among other things, will spur long-term savings).

[2]President Clinton's Fiscal Year 1997 Supplemental Budget Message (Budget Supplement Chapter 12: Promoting Tax Fairness) (legislative proposal), 96 TNT 56-42, March 19, 1996, *available in* LEXIS, Fedtax Library, TNT Files (stating the budget proposes tax reforms that "encourage activities that foster economic growth"); Administration's News Conference Presenting the Administration's Fiscal Year 1997 Budget Proposal, 1996 FDCH Political Transcripts, March 19, 1996, *available in* LEXIS, Nexis Library, CURNWS File (President Clinton stating "our nation must change course and once again provide growth and opportunity for the American people" and emphasizing the Administration's commitment to job creation, low inflation and productivity).

Administration's constructive sale proposal. We believe that it is counterproductive to attack a relatively few abusive transactions with a proposal so broad that it would prevent a large number of taxpayers from entering into prudent, short-term (for example, transactions of nine months or less) risk management transactions.

In light of the foregoing, we urge that any provision relating to constructive sales in any budget or tax legislation be narrowly drawn so as to capture only abusive transactions while not encompassing legitimate, short-term hedging transactions.

Sincerely yours,

Sheila C. Bair

Sheila C. Bair

MAYER, BROWN & PLATT

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May 13, 1996

Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth Office Building
Washington, D.C. 20515

Re: President's Proposal To Tax S Corporation <u>Conversions and Need for S Corporation Reform</u>

Dear Phil:

These comments are submitted in response to the Chairman's April 15 request for public comments on the Clinton Administration's proposal to impose income tax upon certain S corporation conversions.

In summary, the proposal should be rejected. It is inconsistent with sound realization principles of current law and policy and it would further complicate the tax law. Moreover, it is inconsistent with much-needed S corporation reform and simplification which should be promptly enacted.

<u>Current Law</u>

Under current law, an S corporation election is not a taxable event. Under section 1374, however, the net built-in gain on appreciated assets of a C corporation that makes an S corporation election is taxed at the highest corporate rate if the electing corporation sells such assets within ten years of the election. Such gain, net of the corporation's tax, is also taxed at the shareholder level. If the S corporation holds the appreciated assets for continued use in its trade or business, no tax is imposed on the built-in gain.

<u>The Clinton Proposal</u>

The Clinton Administration has proposed to tax both corporations and shareholders on the built-in gain on appreciated assets at the time of an S corporation election, if the electing C corporation is valued at more than $5 million. A conversion, whether by a C corporation electing S corporation status or by a C corporation merging into an S corporation, would be treated as a liquidation of the C corporation followed by a contribution of the assets to a S corporation by the recipient shareholders. Thus, the proposal would require immediate gain recognition by both the corporation (with respect to its appreciated assets) and its shareholders (with respect to their stock) upon the conversion to S corporation status.

The Proposal Is Inconsistent with Basic Realization Principles

The proposal is inconsistent with the long-standing realization requirement. Gain or loss generally is not taxable unless a taxpayer sells or disposes of assets, for two important reasons.

> First, if an event is deemed taxable but produces no liquid assets with which to pay the tax, the imposition of the tax presents both an undue hardship upon the taxpayer and encourages or requires the diversion of other productive assets to pay the tax.
>
> Second, the imposition of the income tax upon the mere adapting of an ongoing business would discourage productivity. This principle is reflected in the various non-recognition provisions of the income tax law, including the reorganization provisions and current section 1374.

For precisely these reasons, an S corporation election is not a realization event. Because no asset is sold, no cash with which to pay either the corporate or individual tax is generated. In addition, the capital and assets of the C corporation would continue to be utilized in the same business; there is no shifting or transfer of assets in any meaningful economic sense. Thus, the proposal contradicts the established and fundamental principle that the income tax is imposed upon dispositions, not upon mere appreciation.

The Proposal Would Further Complicate the Tax Law

Enactment of the proposal would complicate existing law by requiring valuations of the electing (non-publicly traded) corporation and of its appreciated assets. These valuations are expensive, time-consuming and generate litigation.

The Proposal Is Inconsistent with the Much Needed S Corporation Reforms in the Balanced Budget Act

In addition to its inconsistency with the underlying principles of the income tax law, the proposal contradicts the general tax policy reflected in the Balanced Budget Act.

Enactment of the President's proposal would impose confiscatory corporate and shareholder level tax upon an S corporation election, regardless of whether the appreciated assets continue to be used by the S corporation in its business. This undoubtedly would have a chilling effect on S corporation elections.

The Balanced Budget Act included over one dozen non-controversial proposals to simplify and encourage the use of S corporations. They should be adopted without further delay. Enactment of the President's proposal would substantially contradict and undermine the Balanced Budget Act's policy of facilitating S corporations. Moreover, the proposal also undercuts the pro-investment and capital formation policies of the Balanced Budget Act. It should be rejected.

Accordingly, the Committee should reject the President's proposal and approve the much need S Corporation reform and simplification.

Sincerely,

Preferred Income

F U N D

May 14, 1996

Phillip D. Moseley, Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Moseley: In re: Request dated 4-15-96 for written comments on new revenue provisions in President's fiscal year 1997 budget

On behalf of over 30,000 shareholders of the Preferred Income Fund and its two "sister funds", the Preferred Income Opportunity Fund and the Preferred Income Management Fund, we want to express our strong opposition to the **proposed reduction in the Intercorporate Dividends Received Deduction ("DRD") from 70% to 50%** contained in the fiscal 1997 budget recently submitted by the Administration.

These three funds, which I shall refer to collectively as the "Funds", are closed-end investment companies listed on the New York Stock Exchange with total assets of approximately $625 million. Their portfolios are invested almost exclusively in traditional preferred stocks that qualify for the Dividends Received Deduction.

The holders of the Funds' common stocks are primarily small individual investors, ordinary people seeking secure income for themselves and their IRAs. They include relatively few corporate investors who are able to take advantage of the DRD. The Funds have also issued a total of $205 million of auction rate preferred stocks, ranking senior to their common shares, which are typically held by taxpaying domestic corporations.

If the effective tax rate on dividends were increased as proposed, the holders of the Funds' common stock would suffer both an increase in the cost of the senior capital raised by the Funds in the auction rate preferred market and significant depreciation in the market value of the Funds' portfolios. In response to the announcement, in December 1995, of the proposed reduction in the DRD, the cost of issuing auction rate preferred stock increased by roughly 3/8%. In addition, the market prices of the Funds' common stocks declined by 5%-6% in the week following the announcement, an aggregate loss of market value of about $20 million for the holders of the Funds' common stock.

The proposed reduction in the DRD reflects a basic misconception about the structure of the preferred stock market. As covered in a separate comment letter being submitted by Flaherty & Crumrine, Incorporated, the Funds' investment adviser, it is unlikely that the change would produce significant additional revenue for the Treasury because of its impact on yield relationships in the market. Moreover, the Administration's proposal appears to be preoccupied with corporate recipients of dividends. Our Funds are only one example of the large role that individual investors now play in the preferred stock market.

PREFERRED INCOME FUND INC., 301 E. COLORADO BLVD., SUITE 720, PASADENA, CA 91101 (818) 795-7300

May 14, 1996

We strongly urge that the reduction in the Intercorporate Dividends Received Deduction be rejected as an ineffective attempt at raising corporate tax revenue that would inflict unwarranted damage upon all investors in preferred stocks, corporate and individual alike. A change in fundamental tax policy such as this should not be made without thorough consideration of its pervasive impact on the capital markets in the United States.

Very truly yours,

Robert T. Flaherty,
Chairman of The Board and CEO
Preferred Income Fund
Preferred Income Opportunity Fund
Preferred Income Management Fund

RTF:ll

PSA

The Bond Market Trade Association

Public Securities Association
1445 New York Avenue, NW, 8th Fl.
Washington, DC 20005-2158
(202) 434-8400 Fax: (202) 737-4744
http://www.psa.com

Statement of the Public Securities Association

to the Committee on Ways and Means
U.S. House of Representatives

on Tax Proposals in the President's 1997 Budget

May 15, 1996

The Public Securities Association (PSA) appreciates the opportunity to present our views on certain tax provisions contained in the president's fiscal year 1997 (FY 97) budget proposal. PSA is the bond market trade association, representing securities firms and banks that underwrite, trade and sell debt securities, both domestically and internationally. Although we have commented before the Ways and Means Committee on numerous occasions in the past, we have only recently begun focusing on issues related to the corporate bond market and capital financing for corporations.

PSA strongly supports a balanced budget. We believe that balancing the federal budget would engender greater capital investment and economic growth. We are pleased and encouraged that the budget debate has progressed so far over the past 17 months. Both the Congressional leadership and the administration now support a balanced federal budget by 2002. Differences remain over the details related to achieving balance, but significant progress has been made, and we remain hopeful that an agreement will eventually be reached.

Although we are encouraged that the administration has proposed a balanced budget, we are firmly opposed to several tax provisions contained in the proposal. If enacted, these tax proposals would discourage capital formation and would make it more expensive for state and local governments and corporations to finance new investment. PSA believes that capital investment, both public and private, is a fundamental component of higher economic productivity and, ultimately, of improved living standards for all Americans. It is vital to our continued competitiveness in the world economy. Indeed, one of the most important benefits of balancing the federal budget would be higher savings rates brought about by less government borrowing and lower interest rates, which would foster more capital investment. We believe that our tax system should encourage and support savings and investment. Unfortunately, many of the tax provisions in the administration's budget would do just the opposite. It is ironic that the administration would propose legislation that is designed to balance the federal budget, thereby lowering interest rates and fostering investment, and at the same time propose tax changes that would make it more difficult for state and local governments and corporations to finance such investment.

This statement focuses principally on four of the tax proposals contained in the administration's budget: 1) extending *pro rata* disallowance of tax-exempt interest expense to all corporations; 2) denying interest deductions on certain debt instruments; 3) deferring original issue discount deductions on convertible debt; and 4) reducing the dividends-received deduction to 50 percent. Together, these proposals represent an attack on capital formation and new investment, and we urge their defeat.

PSA is deeply troubled by the characterization of these proposals as "corporate loophole closers" and as the "elimination of unwarranted benefits." We take particular issue with Treasury's description of its proposals as ways to curb "abusive transactions." These tax proposals represent fundamental departures from long-standing tax policy related to corporate interest expense deductions and the multiple taxation of corporate earnings. The only way that provisions in current law affected by the administration's proposals could be considered "loopholes" is if permitting corporations to keep their income after being taxed only once or twice were a loophole. In that vein, in addition to discussing the specific proposals described above, our statement will also address some overriding policy considerations related to the taxation of financial instruments, multiple taxation of investment income, and the distinction for tax purposes between corporate debt and equity.

When the administration's tax provisions were first proposed on December 7, 1995, many were offered with an immediate effective date. As the balanced budget negotiations between Congress and the administration proceeded in late 1995 and early 1996, there was considerable uncertainty and confusion regarding whether financing transactions which would be affected by the proposals would be subject to the December 7 effective date if the proposals were enacted into law with a balanced budget bill. Although the administration attempted to address this uncertainty with a series of statements related to the effective dates of the proposals, the statements applied to only a very limited number of pending transactions. The uncertainty created by the existence of tax proposals with a retroactive effective date essentially shut down the market for certain financial instruments. Corporations that had been planning to issue securities to finance new investment had either to employ alternative and costly financing mechanisms or to simply put off their investment until the issue of effective dates was resolved.

The March 29, 1996 joint statement by House Ways and Means Committee Chairman Bill Archer and Senate Finance Committee Chairman Bill Roth on the future effective dates of the pending proposals put to rest the market's concerns over when the administration's tax proposals would be applied if they are ever enacted. The statement by Chairmen Archer and Roth has permitted market participants to continue to raise capital in the most cost-effective way to finance new investment. We are grateful to the two Chairmen for their efforts in this regard.

Since the administration first offered the above tax proposals late last year, many individuals and groups, including numerous members of Congress, have expressed vocal opposition to their enactment. The complete list of individuals and organizations opposing the administration's proposals is much too lengthy for inclusion in this statement. However, several communications by members of Congress are noteworthy. We are aware of the following statements of opposition to the administration's proposals by members of the House of Representatives and Senate, both Republicans and Democrats:

- Letter from 35 Senators to Treasury Secretary Rubin opposing the administration's *pro rata* disallowance proposal, March 6, 1996
- Letter from Ways and Means Committee Chairman Bill Archer (R-TX) opposing the *pro rata* disallowance proposal, January 19, 1996
- Letter from Ways and Means Committee Chairman Bill Archer (R-TX) to President Clinton opposing certain administration tax proposals, December 11, 1995
- Letter from 13 Republican members of the Ways and Means Committee opposing the *pro rata* disallowance proposal, December 15, 1995
- Letter from 21 freshman Republican House members opposing the administration's corporate tax proposals, December 20, 1995
- Bipartisan letter from 16 members of the Ways and Means Committee opposing the *pro rata* disallowance proposal, December 22, 1995
- Letter from Sen. Patrick Moynihan (D-NY) to Treasury Secretary Rubin opposing the *pro rata* disallowance proposal, March 6, 1996
- Letter from Sen. Alfonse D'Amato (R-NY) to Sen. Robert Dole (R-KS) opposing the administration's corporate tax proposals, December 20, 1995
- Letter from Sen. Kay Bailey Hutchison (R-TX) to Treasury Secretary Rubin opposing the *pro rata* disallowance proposal, April 4, 1996
- Letter from Rep. Phil English (R-PA) opposing the administration's corporate tax proposals, February 27, 1996
- Letter from Rep. Kenneth Bentsen, Jr. (D-TX) opposing the *pro rata* disallowance proposal, January 10, 1996

Municipal Finance Proposal

Extend pro rata disallowance of tax-exempt interest expense to all corporations

Under current law, investors, including corporations, are not permitted to deduct the interest expense associated with borrowing to finance purchases of tax-exempt securities. Financial institutions that earn non-qualified tax-exempt interest are automatically disallowed a portion of their interest expense deduction in proportion to the ratio of municipal bond holdings to total assets. Non-bank corporations that earn tax-exempt interest, in order to avoid a loss of interest-expense deduction, must demonstrate that they did not borrow to finance their purchases. Under an IRS procedure in place since 1972, as long as a corporation's tax-exempt bond portfolio does not exceed two percent of its total assets, the IRS does not attempt to determine whether the corporation borrowed to finance its municipal bond holdings. This is the so-called "two-percent *de minimis* rule." The administration's proposal would effectively repeal this "safe harbor" and automatically deny corporations that earn tax-exempt interest a *pro rata* portion of their interest expense deduction.

The administration's proposal would raise the costs of borrowing for state and local governments, and would make it more expensive to finance new investment. The Treasury Department argues that the proposal would not significantly affect municipal borrowing rates. In an April 23, 1996 letter to 35 Senators who actively oppose the administration's proposal, Treasury Secretary Rubin argues that "eliminating the 2 percent *de minimis* rule will not materially affect the costs of borrowing for State and local governments" because non-financial corporations hold only about 5 percent of outstanding tax-exempt bonds. In other words, the administration argues, the departure of non-financial corporations will at worst have only a minimal influence on total municipal market conditions. While it is true that non-financial corporations account for a small percentage of total municipal securities outstanding, the administration's argument fails to recognize the absolutely vital role they play in three important market segments: short-term municipal notes, state and local government housing and student loan bonds, and municipal leasing transactions. The effects of the administration's proposal would be most felt by state and local governments in these three areas.

<u>Short-term municipal note market</u>

State and local governments issue short-term securities to finance a variety of programs and services. The most common use of short-term financing is to fund mismatches between revenues and expenditures. States and localities may incur expenditures before they receive tax and other revenues. Through short-term borrowing, state and local governments can finance temporary cash-flow shortfalls. States and localities also issue longer term bonds that are designed to behave like short-term instruments in order to appeal to certain investors and to take advantage of prevailing market conditions. These longer term "variable rate demand notes" (VRDNs) are issued to finance a variety of public investment projects.

Non-financial corporations are major purchasers of short-term municipal notes and VRDNs. Corporations buy short-term municipals as a cash management vehicle. In doing so, corporations finance their municipal investments from surplus cash and working capital accounts, not from the proceeds of borrowing. Corporate investment in the municipal market is almost never tied to corporate borrowing in any way. By participating actively in the short-term market, corporations help to keep municipal borrowing rates incredibly stable. Currently, short-term municipal borrowing rates are approximately 65.5 percent of comparable taxable rates. This ratio has remained virtually constant in recent years, due largely to participation in this market by corporations. Indeed, during rare occasions when corporations as a group for cyclical reasons reduce their investment in the municipal market, short-term municipal borrowing rates suffer, sometimes rising as much as a percentage point for short periods of time. The ratio of longer term municipal borrowing rates to taxable rates is much more volatile, ranging in recent years from 75 to 90 percent, since corporations do not actively participate in the market for longer dated municipal bonds. The administration's proposal would effectively discourage virtually all corporate investment in the municipal market. In doing so, the proposal would significantly raise the cost of short-term borrowing for state and local governments and would make short-term municipal rates more volatile relative to taxable rates.

The administration argues that current rules related to the deduction of interest expense permit inappropriate manipulation of tax liability by non-financial corporations. In his April 23 letter, Secretary

Rubin alleges that the law as presently written is used by non-financial corporate taxpayers "to extend the benefits of exempt interest income to debt-financed holdings." Implicit in the administration's argument is the assumption that corporations have deliberately engaged in arbitrage practices by borrowing in the short-term market and investing in tax-exempt obligations. Actually, there is no evidence to suggest that corporations are engaging in abusive, arbitrage-motivated transactions. Holdings of municipal bonds have averaged only 0.47 percent of the financial assets and 0.15 percent of the total assets of non-financial corporations since 1987,[1] a level that has remained fairly consistent. Moreover, given that the top corporate income tax rate is 35 percent and the short-term tax-exempt/taxable yield ratio hovers around 65.5 percent, the level of after-tax return available to corporations in the municipal market simply does not justify arbitrage transactions.

Also in his April 23 letter, Secretary Rubin explains that the benefits of the two-percent *de minimis* rule "are not available, nor should they be, to banks, securities brokers and dealers, or insurance companies. Eliminating the *de minimis* rule . . . will result in all corporations being treated in a more even-handed manner." In reality, the proposal would result in grossly unfair treatment for a large number of corporations which, under current law, may legitimately invest in the tax-exempt bond market by clearly showing they did not borrow to do so. It would do this through a provision that would extend the *pro rata* disallowance of interest expense on a combined basis to "affiliated companies" that file consolidated returns and by eliminating the present-law analysis of the intent of the corporation.

Assume, for example, that a corporate subsidiary invests in municipal securities and that the subsidiary carries no debt, incurs no interest expense, and can therefore conclusively demonstrate that it did not borrow to finance its municipal bond holdings. Assume also that a second corporate subsidiary incurs interest expense but does not invest in municipal securities, and that the two subsidiaries are "affiliated" and file a consolidated tax return. Under the administration's proposal, the consolidated corporation would be disallowed a portion of its interest expense deduction even though it could prove conclusively that the first subsidiary did not borrow to finance its investment in tax-exempt securities.

The above example is similar to a situation that exists currently. Traveler's check and money order companies, due to state regulatory constraints on their investments, invest considerable sums in tax-exempt securities, although they carry no debt and incur no interest expense. Under the administration's proposal, to the extent that these corporations file consolidated returns with affiliated companies that do incur interest expense, they would be discouraged from investing in state and local bonds. The proposal would effectively discourage all corporate investment in the municipal bond market, regardless of whether corporations do, indeed, engage in unwanted arbitrage transactions.

The proposal would explicitly exempt insurance companies from the affiliated companies provision. When it was first announced in December 1995, there was considerable concern among municipal market participants that the proposal would apply to property and casualty insurance companies, which are major investors in the municipal market. Early this year, when the administration released proposed legislative langage for its proposal, it became clear that insurance companies would be largely exempt from the provision's potential effects. If it had been structured to apply to property and casualty insurers, the proposal would have had truly catastrophic effects on municipal bond issuers. As it is, municipal financing costs would rise substantially under the provision. Nevertheless, we are pleased that insurance companies have been "carved out" of the proposal.

Non-financial corporations currently purchase a substantial portion of newly issued short-term state and local securities. They are, in effect, buyers of last resort that prevent excessive interest rate volatility. This becomes evident at certain times of the year, such as the weeks preceding federal tax payment due dates, when tax-exempt money-market funds, the only other major source of demand for short-term state and local securities, tend to sell large blocks of securities to meet shareholder redemptions. Short-term tax-exempt interest rates tend to rise, inducing corporations that have excess cash available to purchase the municipal paper being sold. Thus, corporations are a major force in helping to keep short-term tax-exempt rates stable. In their absence, short-term tax-exempt rates may have to rise in times when other short-term investors are net sellers. Non-financial corporations would not be major buyers of short-term municipals in the future under the proposal, with the result being higher, more volatile state and local borrowing rates.

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[1] Source: Federal Reserve Board.

The proposal would also affect rates on shorter term, interest-bearing municipal bonds with maturities of, for example, two to five years, so called "short serial" bonds. Short serial bonds are issued to finance a wide variety of public facilities and projects. Even though corporations are not major investors in this segment of the market, yields on these instruments are closely related to yields in the municipal note market. As rates on municipal notes rose, so would rates on short serial bonds, albeit to a lesser degree. The proposal would also significantly affect the municipal swaps market. State and local governments regularly enter into swap contracts as a way to manage their liabilities and reduce their costs of financing. The proliferation of municipal swaps over the past several years has improved the efficiency of the municipal bond market. Many municipal swaps are tied to an index of short-term municipal borrowing rates, the PSA Municipal Swap Index. If the administration's proposal were enacted, short-term municipal borrowing rates would be higher and more volatile. This would make it less efficient and more expensive for states and localities to use swap contracts to reduce their borrowing costs.

Municipal leasing transactions

The proposal would also have profound effects on municipal leasing. States and localities routinely lease assets and equipment, such as school buses, police cars, and computers. If the administration's proposal were adopted, equipment lessors estimate that their cost of financing for state and local governments would increase dramatically. After originating municipal lease transactions, most lessors generally sell their financing contracts to private funding sources to generate the capital they need to continue to operate their business. Those who invest in tax-exempt leasing include corporations, commercial banks and investment banks. Individuals and mutual funds, through certificates of participation, also purchase tax-exempt leases. Although the administration's proposal would not apply "to certain nonsalable tax-exempt bonds acquired by a corporation in the ordinary course of business in payment for goods and services sold to a state or local government," this intended relief is illusory. The vast majority of equipment manufacturers who sell to state and local governments prefer not to hold municipal leases because they do not want to tie up their capital. These companies generally sell their financing contracts to third party investors.

Even where a manufacturer owns a captive finance company, the manufacturer's exemption is lost when the lease is sold to the finance subsidiary. Even in the limited cases where a manufacturer may wish to retain a leasing obligation on its books, the ability to sell the asset in the future if necessary — the liquidity of the municipal leasing market if the vendor were to sell the obligation — serves to reduce lease financing costs for states and localities. The administration's proposal would discourage vendor financing of capital equipment leased to states and localities. As a direct result, the cost of new capital investment by state and local governments would rise substantially.

Housing and student loan bonds

The housing and student loan sectors of the municipal market would also be negatively affected by the administration's proposal. State and local governments issue bonds to finance home mortgage loans for low- and moderate-income families as well as loans for low-income multi-family rental projects. Both these programs provide limited, targeted, below-market financing for housing. Over the past several decades, state and local housing bonds have provided tens of billions of dollars in rental housing for low-income families and have made home ownership available to families who may not have been able to finance a home through any other source. Student loan bonds are issued to finance below-market loans to college students who may not otherwise be able to obtain tuition financing.

Together, Fannie Mae, Freddie Mac, Sallie Mae and other government-sponsored corporations and agencies hold about $8.6 billion of outstanding municipals. These entities invest primarily in state and local housing bonds (Fannie Mae and Freddie Mac) and student loan bonds (Sallie Mae). Under the administration's proposal, these organizations would simply stop buying municipals. State and local housing and student loan agencies would become almost completely dependent on individual investors, acting directly or through mutual funds. Individuals tend to be more volatile and less consistent sources of demand. Higher financing costs in these sectors ultimately mean less financing of low- and moderate-income single family and multi-family housing and less student loan financing.

The loss of virtually all non-financial corporate demand in the municipal market would inevitably cause borrowing rates to rise for states and localities throughout the country. Since they would be captive to individual investor sentiment and fund flows, municipal rates would become much more volatile and would remain substantially higher than under current law. Specifically, short-term rates would be more volatile, particularly when, for seasonal reasons, individuals are net sellers of municipals. Housing and student loan bond rates would tend to increase.

The administration's proposal would effectively represent a tax imposed by the federal government on state and local governments in the form of higher borrowing rates. Corporate investors in the municipal market would pass on to state and local bond issuers 100 percent of the costs imposed by the proposal. Industry analysts have estimated that increases in state and local financing costs in certain market sectors could range from 20 to 75 basis points. Increases in lease financing costs could be even higher. The proposal is short-sighted and counter-productive, and we urge its rejection.

Corporate Finance Proposals

The characterization of debt and equity

Three of the administration's proposals relate to the taxation of financing instruments issued by corporations. The proposals reflect a fundamentally new approach to the characterization for tax purposes of corporate debt and equity, an approach which is a radical departure from accepted tax policy and which would entail negative consequences for corporate investment in capital assets. Indeed, the administration's proposals represent a significant departure from existing Internal Revenue Service (IRS) rules and practices regarding the classification of debt and equity. Currently, in distinguishing between the two, the IRS considers the following eight factors[2]:

- whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future;
- whether holders of the instruments possess the right to enforce the payment of principal and interest;
- whether the rights of the holders of the instruments are subordinate to rights of general creditors;
- whether the instruments give the holders the right to participate in the management of the issuer;
- whether the issuer is thinly capitalized;
- whether there is identity between holders of the instruments and stockholders of the issuer;
- the label placed upon the instruments by the parties; and
- whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.

According to the IRS, "no particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity. The weight given to any factor depends upon all the facts and circumstances and the overall effect of an instrument's debt and equity features must be taken into account."

The existing guidelines leave unanswered questions regarding the tax status of particular financial instruments and products. Even more important, the guidelines fail to recognize some fundamental differences in the nature of the income derived from debt and equity instruments and place undue emphasis on accounting factors in distinguishing between the two. PSA believes that there are several general, guiding principles that should apply in defining debt and equity for tax purposes. Before addressing the administration's proposals specifically, a discussion of these principles would be useful.

<u>Single taxation of corporate earnings</u>

The problem of double and triple taxation is a fundamental concern for PSA under prevailing tax law. Under current law, corporations generally may deduct interest payments to creditors, but may not deduct dividend payments to equity investors. Because interest payments are deductible and dividend payments are not, current law favors debt over equity as a means of corporate finance, not from any justifiable policy consideration, but simply as a historical anomaly. Make no mistake: tax considerations play a role in a corporation's choice of financing mechanism.

Because corporate equity is not afforded the same tax treatment as debt, corporations' earnings are often taxed multiple times. If a corporation holds stock in another corporation, it is taxed on the dividends paid on that stock to the extent that the dividends do not qualify for the dividends received

[2] Internal Revenue Service, Notice 94-47.

deduction (DRD). It is also, of course, taxed on its earnings from all other sources. If the corporation pays dividends to a tax-paying investor, that investor pays taxes on the dividends. To the extent that accumulated, unpaid earnings are represented in the appreciated price of a stock, those earnings are taxed as capital gains when shares are sold by a taxable investor. If the stock is part of an estate, the holdings are taxed when the estate is distributed. The effect of these multiple levels of taxation is to raise financing costs for corporations, reducing incentives for capital formation, and creating serious concerns about global competitiveness.

Ultimately, the solution to the problem of multiple taxation of corporate earnings — short of moving to an entirely new system of taxation, such as a consumption tax — is to integrate fully the corporate and individual tax systems. Many of the proposals for corporate tax integration which have been circulated in recent years suggest either abolishing the corporate income tax altogether and taxing all corporate earnings at the level of investors, or exempting investment earnings from taxation at the individual level and fully subjecting all corporate earnings, whether paid as interest or dividends, to the corporate income tax.[3] PSA would fully support further study and consideration of the issue of corporate tax integration with the goal of amending the federal tax code to ensure that corporate earnings are not taxed more than once. Ultimately, we would favor a tax system without arbitrary distinctions between debt and equity and where financing decisions were made solely on the basis of the lowest cost source of capital. Short of fully integrating the individual and corporate tax systems, however, we firmly believe that in cases where a reasonable question exists as to the characterization of an instrument as debt or equity, tax law should favor treatment as debt so as to minimize the problem of multiple taxation.

The nature of equity investment

Equity and debt investments are fundamentally different in an important sense. An investor buys an equity instrument as a way to participate directly in the long-term growth of the issuing corporation. Such is the case with common stock. Debt investments do not afford this benefit to holders. In buying a debt instrument, an investor is purchasing an income stream or interest accrual, not a participation in the success or failure of a company. It is true that a debt investor can benefit from a corporation's strong performance — if a corporation's financial condition improved enough so that its credit rating were upgraded, for example — or can be hurt by a corporation's poor performance — if a corporation were downgraded or the company went bankrupt. However, the potential risks and rewards of a corporate debt investment related to the performance of a company usually represent only a very small aspect of an investor's total return on his or her investment.

Ultimately, the characterization of an instrument as equity or debt should rest on whether by buying the instrument in question, an investor is purchasing a direct participation in the long-term growth of the issuing corporation, or a stream of cash flows based on an agreed upon rate. For most financial instruments, this distinction is obvious. Common stock clearly is equity. Senior and subordinated corporate bonds clearly are debt. Traditional preferred stock, since it represents an interest in a stream of fixed dividend payments, also would fall under the definition of debt. Hybrid instruments — securities which are debt in virtually all respects except for their accounting treatment, also known as preferred debt securities, fixed-rate capital securities, and by numerous proprietary product names — also represent interests in fixed streams of payments, and therefore would be debt.

Accounting treatment and tax policy

How a financing instrument is treated under accounting rules should play no role in determining its tax treatment. Distinguishing between debt and equity for accounting purposes serves a goal fundamentally different from that for tax purposes. The characterization of financial instruments under accounting rules is based on an issuer's payment obligations and an investor's rights in bankruptcy. The rules also provide common definitions and conventions so that the accounting statements of one company are easily comparable to those of another. The distinction under the tax code exists so that similar types of income are afforded similar tax treatment. There is no reason to expect that the treatment of a given financial instrument under the tax code should necessarily mirror its treatment under generally accepted accounting principles (GAAP) or under the information disclosure requirements of securities statutes and regulations.

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[3] See, for example, U.S. Department of the Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once*, January 6, 1992.

Indeed, relying on accounting rules as the basis for how a particular instrument is taxed would effectively grant tax policy authority to the Financial Accounting Standards Board and the Securities and Exchange Commission (SEC). With all due respect to these two highly regarded organizations, PSA firmly believes that tax policy authority should rest with Congress and, to the extent such authority is granted in law, the Treasury Department. The designation of certain hybrid financial instruments as non-debt liabilities in SEC filings, for example, relates to accounting concerns with respect to their status in bankruptcy, not to the nature of the income or other benefits received by the holder or to the obligations of the issuer.

Deny interest deduction on certain debt securities

The administration's budget plan contains a proposal to deny corporate interest expense deductions for debt with a maturity longer than 40 years and instruments with maturities longer than 20 years not characterized as debt in an issuer's SEC filings. This proposal appears to be aimed at eliminating the interest deductibility of innovative new financial instruments, such as hybrid preferred debt and long-dated corporate bonds, on alleged grounds that they are improperly treated as equity for accounting purposes and debt for tax purposes. The administration has characterized this proposal as a way to curb "abusive" transactions. However, there is no evidence that corporations have in any way attempted to skirt existing distinctions between debt and equity or have otherwise engaged in "abusive" activity. PSA disagrees with the administration that the current tax treatment of these instruments needs to be changed.

A careful analysis of the affected instruments reveals that they possess the critical attributes of debt. Indeed, Treasury's proposal does not rely on any of these attributes to curtail the interest deductibility of these instruments. Rather, Treasury has focused on the fact that hybrid preferred debt products are not typically shown as debt on a company's balance sheet. The reality is, balance-sheet treatment of these instruments has never before been relevant to their tax treatment and whether they are identified as debt obligations for tax purposes.

Hybrid instruments issued through a trust are a case in point. A company utilizing these instruments issues debt obligations to a trust which, in turn, issues trust securities to investors. The transaction is structured in this way to improve the attractiveness of the securities to the public. Because these debt obligations are issued through a trust, they are not shown on an issuer's balance sheet as debt, although the status of the obligations as indebtedness is clearly disclosed in a footnote to the company's balance sheet.

The balance-sheet characterization of hybrid preferred instruments as a non-debt liability does not alter the conclusion that the underlying debt securities possess all the critical attributes of debt. This is clearly illustrated by the facts that:

- Investors in these instruments are the legal owners of an undivided interest in the underlying debt obligations, and they enjoy all the legal rights and economic benefits as if they had purchased the debt obligations directly from the issuer, rather than certificates from the trust. In addition, holders of these instruments do not enjoy any participation in an issuing corporation's growth, as do holders of common stock.

- Issuers of these securities — despite their ability to extend an interest payment period for up to five years — have an absolute obligation to pay interest and principal at maturity.

Contrary to Treasury's revenue projections, this proposal would likely fail to raise revenue. Issuers that are affected by the proposed legislation would either choose to issue hybrid preferred securities with a maturity of 20 years or less, or they would maintain the 20-plus year maturity of the instruments and issue them directly to investors, rather than through a partnership or trust. In virtually no case would an issuer substitute its hybrid financing with equity. In any case, Treasury's proposal will ultimately fail to reduce the amount of interest issuers deduct, and it will therefore be unlikely to raise tax revenue.

The administration has proposed capricious and arbitrary distinctions as to what qualifies as debt financing eligible for interest-expense deduction. Under the proposal, two otherwise identical debt securities, one with a maturity of 40 years and the other with a maturity of 41 years, would be treated in entirely different ways. The definition of equity should rest on more defensible grounds by encompassing only securities where returns are directly related to the long-term growth of the issuing corporation, such as common stock. Neither long-dated corporate bonds nor debt/equity "hybrids" afford this benefit to holders. In both cases, the holder is buying an income stream, not an equity participation. Any distinction based solely on one factor — the maturity of an instrument — ignores long-standing definitions and conventions regarding what constitutes debt financing.

Defer original issue discount on convertible debt

The administration has proposed to change the tax treatment of original issue discount (OID) on convertible debt securities. OID occurs when the stated coupon of a debt instrument is below the yield demanded by investors. The most common case is a zero-coupon bond, where all the interest income earned by investors is in the form of accrued OID. Under current law, corporations that issue debt with OID may deduct the interest accrual while bonds are outstanding. In addition, taxable OID investors must recognize the accrual of OID as interest income. Under the administration's proposal, for OID instruments which are convertible to stock, issuers would be required to defer their deduction for accrued OID until payment was made to investors in cash. For convertible OID debt where the conversion option is exercised and the debt is paid in stock, issuers would lose the accrued OID deduction altogether. Investors would still be required to recognize the accrual of OID on convertible debt as interest income, regardless of whether issuers took deductions.

The administration's proposal is objectionable on several grounds. First, convertible zero-coupon debt has efficiently provided corporations with billions of dollars in capital financing. The change the administration proposes would significantly raise the cost of issuing convertible zero-coupon bonds, and in doing so would discourage corporate capital investment. Second, the administration's presumptions for the proposal are flawed. The administration has argued that convertible zero-coupon bonds represent a *de facto* equity investment, and should be treated as such. However, performance does not bear out this claim. In fact, of the convertible zero-coupon debt retired since 1985, approximately 70 percent has been retired in cash, and only 30 percent has been converted to stock. Indeed, the market treats convertible zero-coupon bonds more as debt than as equity.

Third, and perhaps most important, the administration's proposal violates the basic tenet of tax symmetry, the notion that the recognition of income by one party should be associated with a deduction by a counterparty. This fundamental principle exists to help ensure that income is taxed only once. Under the proposal, investors would be taxed fully on the accrual of OID on convertible zero-coupon debt, but issuers' deductions would be deferred or denied. The proposal would compound problems associated with the multiple taxation of investment income, thereby raising the cost of corporate capital.

Because the proposal would exacerbate problems of multiple taxation of corporate income and because it would raise the cost of corporate capital investment, PSA urges the rejection of the administration's proposal.

Limit dividends-received deduction (DRD)

Under current law, corporate taxpayers that earn dividends on investments in other corporations are permitted a tax deduction equal to at least 70 percent of those earnings. The deduction is designed to mitigate the negative economic effects associated with multiple taxation of corporate earnings. The administration has proposed reducing the minimum dividends-received deduction (DRD) to 50 percent, which would increase the taxation of corporate earnings and discourage capital investment. A companion proposal to modify the DRD holding period would also have a number of negative market effects.

A generous DRD is important because it reduces the effects of multiple taxation of corporate earnings. As discussed earlier, when dividends are paid to a taxable person or entity, those funds are taxed twice, once at the corporate level and once at the level of the taxpayer to whom the dividends are paid. These multiple levels of taxation raise financing costs for corporations, create global competitiveness problems, and generally reduce incentives for capital formation. The DRD was specifically designed to reduce the burden of one layer of taxation by making dividends largely non-taxable to the corporate owner.

Scaling back the DRD would exacerbate the effects of multiple taxation. The change would be tantamount to a tax increase on corporate earnings since the minimum deduction available to certain investors would fall. This tax increase would flow directly to issuers of stock, especially preferred stock, who would face higher borrowing costs as investors demanded higher pre-tax yields. Preferred stock is an especially important source of capital for certain corporations and industries, such as commercial banks and utility companies. In response, corporations would tend to cut capital expenditures, reduce working capital, move capital raising and employment overseas, and otherwise slow growth-oriented investment. Amplifying the competitive disadvantages of multiple taxation of American corporate earnings would be the fact that many of our largest economic competitors have already adopted tax systems under which inter-corporate dividends are largely or completely untaxed. The administration's DRD proposal would thus have a wide range of unintended consequences that would harm the national economy.

Summary

Again, we appreciate the opportunity to comment on the tax proposals contained in the administration's FY 97 budget proposal. Although we strongly oppose many of the administration's proposals on the grounds that they would discourage capital formation and public and private investment, we welcome the Ways and Means Committee's attention to these important issues. We are especially pleased that the proposals are being considered in a more formal and systematic manner than they were during the hectic days of the balanced budget negotiations in late 1995 and early 1996.

We urge the committee's opposition to the four tax proposals we have discussed in our statement. We feel that their ultimate effects are contrary to many of the committee's goals of the past eighteen months: to foster savings and investment and encourage capital formation. We hope our comments are useful, and, as always, we are prepared to offer any additional assistance the committee may need in its continued deliberations.

**STATEMENT
OF
THE S CORPORATION COALITION
IN RESPONSE TO
THE HOUSE COMMITTEE ON WAYS AND MEANS
REQUEST FOR COMMENTS
ON
NEW REVENUE PROVISIONS IN THE
PRESIDENT'S FISCAL YEAR 1997 BUDGET**

This statement is respectfully submitted on behalf of the S Corporation Coalition in response to the Committee's request for comments on revenue provisions that were included in President Clinton's fiscal year 1997 budget, but not in the Balanced Budget Act of 1995. The S Corporation Coalition is a group of companies from across the country representing a wide range of industries that strongly supports the needed reform of the Subchapter S rules that is contained in the S Corporation Reform Act of 1995 (H.R. 2039).

The Coalition appreciates the Committee's interest in public comments on the Administration's new revenue proposals and welcomes the opportunity to express its strong opposition to one of these proposals in particular -- the proposal to treat conversions to S status (and certain transactions involving S corporations) as taxable liquidations. As explained below, the Coalition believes that this proposal is short-sighted, would be harmful to small business, and represents a giant step backward from the goals of Subchapter S. The Coalition respectfully recommends that the Committee reject this proposal, and instead continue its efforts to enact the reform provisions contained in the S Corporation Reform Act.

BACKGROUND

The Administration is proposing to repeal Section 1374 of the Internal Revenue Code and to treat the conversion of a "large" (greater than $5 million in value) C corporation to a Subchapter S corporation as a taxable liquidation of the C corporation, followed by a contribution of assets to the S corporation by the shareholders. The proposal also would apply to transfers of assets from a large C corporation to an S corporation in certain carryover basis transactions (such as mergers). The net effect of the proposal is that converting to S corporation status, or participating in merger transactions involving S corporations and C corporations, could trigger substantial tax liability at both the corporate level (with respect to unrealized asset gain) and at the shareholder level (with respect to stock).

The Administration currently is recommending that its proposal be effective for conversions that are effective for tax years beginning after January 1, 1997, and for asset acquisitions after December 31, 1996.

PROBLEMS WITH THE ADMINISTRATION'S PROPOSAL

As explained below, the Coalition believes that the Administration's proposal would impose an unjustifiable new tax on conversions to S status and mergers with S corporations, would discourage desirable and productive business behavior, would harm small business, and would run completely contrary to Congressional efforts to enact Subchapter S reform legislation.

1. The Proposal Would Make the Tax Cost Too High for Small Businesses to Be Able to Convert to S Status

The Administration's new "toll charge" on converting from a C corporation to an S corporation would represent a substantial new tax burden on small businesses. In effect, the proposal would require a C corporation to pay tax on its conversion to S status as if it had distributed all its assets in liquidation -- even though a converting corporation does not actually dispose of any assets and does not receive any infusion of cash upon conversion. Because of the size of the resulting tax burden, it is very likely that companies that are formed as C corporations simply will not be able to afford to convert to S status.

Consider the case, for example, of a small "Mom and Pop" operation that did not have the benefit of sophisticated legal and accounting advice when it was formed and, as a result, did not know of the possibility of electing to be taxed under Subchapter S. Several years later, however, the company faces a new competitor that has been formed as an S corporation. After consulting with an accountant, the company establishes that it, too, is eligible to elect to be taxed as an S corporation and to be taxed in the manner that Congress deemed appropriate for companies with its characteristics. If the Administration's proposal were law, the company in all likelihood would not be able to convert to S status and to compete on a level-playing field with its competitors; the tax cost of conversion would simply be too high to pay. Clearly, this is not the right result.

2. <u>The Proposal Would Discourage Productive Business Activity between S Corporations and C Corporations</u>

The Administration's proposal to impose a new tax on the merger of a C corporation into an S corporation would substantially increase the cost of certain business combinations and would provide a severe disincentive to engaging in these activities. In this regard, the proposal fails to recognize the important role that mergers and other business combinations can play in making businesses more efficient and improving the productivity of U.S. businesses.

Moreover, the proposal would create an arbitrary set of rules whereby the merger of a C corporation into an S corporation would be taxed very differently from other kinds of merger transactions (such as the merger of two C corporations or of two S corporations). These arbitrary rules would severely distort business decision-making. The decision of whether or not two companies should merge should be based on an evaluation of the business costs and benefits associated with the transaction -- not on tax law considerations that arbitrarily increase the cost of certain kinds of merger transactions

Finally, the Administration's proposed tax on mergers of C corporations into S corporations would represent a substantial departure from well-accepted principles of Federal income tax law governing tax-free reorganizations that have been developed by courts and the Congress over the course of many decades. It would be short-sighted to abandon this body of law and to change fundamental principles of taxation in this manner. Instead, mergers should continue to be treated as tax-free events -- regardless of whether the parties are S corporations, C corporations, or a combination thereof.

3. <u>The Proposal Is Not Necessary to Prevent Tax Abuse</u>

The Treasury previously has suggested that its new tax on conversions and mergers is justified by the need to prevent C corporations from converting to S status as a means of avoiding the Subchapter C corporate level of tax on asset gain. Under current law (Section 1374 of the Tax Code), a corporation that converts to S status pays corporate-level tax on the appreciation in its assets at the time of conversion only if it disposes of those assets within the ten-year "recognition" period following conversion. Treasury has suggested that companies may convert to S status, hold their "built-in gain" assets for ten years, and then, on the expiration of the recognition period, sell their assets. In such a case, the asset gain would be flowed through to the shareholders, but would not be subject to corporate level tax.

This suggestion, however, holds no water. Any company that hopes to be around for ten years has to make its decisions as to whether to sell or hold assets based on business considerations. Indeed, it is hard to imagine a company refusing to sell an asset to a willing buyer simply to avoid the current built-in gains tax.

Moreover, it is important to recognize that converting to S status (or engaging in a merger with an S corporation) is in no way abusive. Indeed, Congress enacted Subchapter S precisely because it determined that companies meeting certain specific eligibility requirements should be able to elect to be taxed in a different manner than under Subchapter C. Thus, companies that convert to S status are not engaging in any inappropriate or abusive conduct; to the contrary, they are engaging in the very activity Congress sought to encourage in enacting Subchapter S.

Finally, it should be noted that Congress already has included a set of rules designed to prevent corporations from converting to S status as a means of engaging in various perceived abuses. For example, as indicated above, Section 1374 currently is designed to prevent C corporations from electing S status in anticipation of an asset sale. Further, Sections 1362 and 1375 are intended to prevent C corporations from electing S status as a means of bailing out their C corporation earnings and profits; these sections, respectively, provide for the termination of the S status of, and the imposition of a corporate level tax on, S corporations that have significant passive investment income and C corporation accumulated earnings and profits. There is no evidence that these rules are not working as intended. As such, there is no reason to impose a draconian new tax on conversions.

4. **The Administration's Proposal Is Completely Contrary to Congressional Goals**

The Administration's proposal also runs completely counter to repeated Congressional efforts to enact Subchapter S reform legislation that would enhance S corporations' access to capital, help preserve family-owned businesses, remove technical traps that befall the unwary, and simplify many of the cumbersome and complex rules that currently apply to S corporations. As you know, the Congress included many of these reform provisions in the Balanced Budget Act of 1995 that was vetoed last fall. In addition, the Committee included many of these provisions in the small business job protection bill it ordered reported yesterday (May 14). Further, previous Congresses have included reform provisions in other tax legislative vehicles, such as The Revenue Act of 1992 (H.R. 11) and the Tax Fairness and Economic Growth Act of 1992 (H.R. 4210). The Administration's proposal represents a drastic departure from the goals pursued by the Congress in these bills and should be rejected.

RECOMMENDATIONS

For the reasons set forth above, the Coalition strongly urges the Committee not to include the Administration's proposal to treat the conversion to S status as a taxable liquidation in any tax legislation, this year or in the future.

Further, the Coalition strongly encourages the Committee to continue its efforts to enact the provisions contained in the S Corporation Reform Act. These reform provisions are good for small business and good for our economy. They remove unneeded complexity from the tax laws, help family-owned business, and enhance small business's access to capital. The Coalition applauds the Committee for including many of the provisions from this bill in the Balanced Budget Act of 1995 and in the small business protection bill it ordered reported yesterday. The Coalition looks forward to continuing to work with the Committee on Subchapter S reform in the future.

The Coalition appreciates the Committee's interest in its views on these significant S corporation issues.

STATEMENT OF THE SECURITIES INDUSTRY ASSOCIATION
TO THE HOUSE COMMITTEE ON WAYS AND MEANS CONCERNING
CERTAIN REVENUE PROVISIONS IN PRESIDENT CLINTON'S
FISCAL YEAR 1997 BUDGET
U.S. HOUSE OF REPRESENTATIVES

May 15, 1996

The Securities Industry Association ("SIA") is pleased to provide comments concerning some of the proposals that were introduced by the President as part of his 1997 budget plan. We are grateful for the opportunity to offer our views to Congress.

Many of the President's proposals would, if adopted, affect the tax consequences of issuing and holding financial instruments, or of entering into various financial transactions (hereafter, the "financial transactions proposals"). SIA brings together the shared interests of about 700 securities firms throughout North America to accomplish common goals. SIA members--including investment banks, broker-dealers, specialists, and mutual fund companies--are active in all markets and in all phases of corporate and public finance. In the United States, SIA members collectively account for approximately 90 percent, or $100 billion, of securities firms' revenues and employ about 350,000 individuals. They manage the accounts of more than 50 million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans. In light of the above, SIA believes it is uniquely qualified to comment on the President's financial transactions proposals, and to offer insights concerning the potential consequences of their implementation.

In general, SIA is strongly opposed to the President's financial instruments proposals. We think it apparent that many of the proposals are desultory responses to a few well-publicized transactions and that they do not represent a coherent approach to the tax treatment of financial instruments and transactions. Indeed, many of the proposals conflict not only with each other, but also with broader principles of federal income taxation and the policies underlying those principles. Set out below are our specific comments on each of the President's financial instruments proposals.

Lowering of the Dividends Received Deduction to 50%

The President's 1997 budget plan includes a proposal to lower the dividends received deduction from 70% to 50%. SIA strongly opposes this proposal, for important policy reasons.

The dividends received deduction is designed to prevent multiple levels of corporate taxation when corporations invest capital in the equity of other corporations. SIA believes the deduction should if anything be increased from 70% back to 80% (where it stood for most of the 1980s), so as to encourage the free flow of capital from "mature" corporations, which have limited opportunities to profitably invest capital, to "growth" corporations which can most productively employ that capital and expand the economy. Surely the imposition of double and triple-level corporate taxation on capital seeking its most productive use is a serious mistake.

Moreover, we believe that lowering the dividends received deduction would have several undesirable collateral effects: First, it would encourage corporations to lend capital to other corporations, rather than make equity investments. The resulting increase in corporate leverage would weaken the stability of the corporate sector. Second, it would reduce the international competitiveness of U.S. corporations by effectively increasing the rate of U.S. corporate-level taxation, a rate which is already much higher than the rate imposed on foreign competitors by many of our trading partners, most of which have already integrated their corporate-level taxes. Finally, it would disrupt capital markets by leading to sudden and unanticipated drops in the values of preferred and other yield-oriented equities that were issued assuming a 70% dividends received deduction.*

Modification of the DRD Holding Period

The President's 1997 budget proposal includes a provision which would effectively eliminate the dividends received deduction if a corporation was hedged against exposure to risk of loss from the relevant stock at the time any dividend was received. Current law simply requires a corporation to hold stock unhedged for at least 46 days before hedging, so as to prevent certain potentially abusive "dividend stripping" transactions where taxpayers are never exposed to any risk of loss at all.

Thus, the proposal would, if adopted, effectively turn a limited anti-abuse rule into a broad prohibition on hedging transactions. It would effectively force corporations to choose between hedging their equity positions for perfectly valid business reasons and retaining the dividends received deduction.

For reasons similar to those set out above in connection with the proposed lowering of the dividends received deduction, SIA strongly opposes this proposal. This proposal would, if adopted, effectively prevent corporations from prudently moving capital to those places in the economy where it can be put to the most productive use. Moreover, SIA believes that the prudent hedging of corporate equity positions should (barring certain limited abuses which are already adequately addressed by a variety of anti-abuse statutes) be actively encouraged by Congress as increasing the stability and flexibility of the corporate economy.

If Congress nevertheless chooses to adopt this proposal, we believe it should be made effective only for transactions entered into after the date on which the proposal is enacted. Many taxpayers have already entered into long-term hedging transactions--such as issuances of exchangeable debt instruments--which cannot be reasonably terminated or otherwise unwound.

Deny Interest Deductions on Certain Debt Instruments

The President's 1997 budget proposal includes a provision which would disallow deductions for interest paid on certain debt instruments that are viewed by the President as having substantial equity characteristics. SIA strongly opposes this provision on two grounds: first, it unnecessarily impedes corporations in their efforts to meet beneficial (and in some cases government mandated) financial objectives designed to maintain their longterm stability; second, it does not provide a cohesive and logical precedent for the characterization of financial instruments.

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* In this regard, if Congress does chose to enact such a provision, we believe it should be made effective only for dividends received on stock acquired by the relevant taxpayer after the date of enactment of the provision.

We understand that the Treasury Department has recently grown concerned with innovations in the structuring of debt instruments. It has observed that some of these structures permit issuers to meet financial, rating agency, regulatory or accounting objectives that can also be met by issuing equity. It has concluded on this basis that the structural innovations are eroding the corporate tax base. Rather than make use of the authority already granted by Congress under Section 385 of the Internal Revenue Code to coherently define the distinction between equity and debt, however, the Treasury Department has returned to Congress seeking an ad hoc disallowance of interest deductions on certain kinds of structured debt instruments-- specifically, the instruments that have been most successfully issued over the past two years.

These instruments are plainly debt instruments under general principles of federal income taxation. They include such popular and well-received instruments as 100-year debt, which is designed to permit issuers to lock in low rates of interest for a long period of time; 30-year debt held through a trust, which is designed to help issuers maintain investment-grade credit ratings; and certain investment units consisting of debt and forward contracts, which are designed to permit issuers to issue stock in the future should a business downturn, or new regulatory requirements, make such an issuance prudent. In short, corporations generally issue these instruments to improve their longterm financial stability and flexibility, and to comply with various regulatory requirements. We think Congress should approve of this.

It is well-known that U.S. corporations can pay less corporate-level tax by issuing more debt and less equity. In this regard, the general increase in the leverage of U.S. corporations poses a much greater threat to the corporate-level tax base than does routine innovation in the structure of any particular debt instrument. Many academics and economists are in favor of integrating the corporate-level tax. Regardless of one's views on the subject, however, the role of debt issuance in our tax system is a complex subject, with arguments on many levels. We simply do not see the advantage of eliminating successful and economically beneficial transactions on an ad hoc basis.

We recognize that investment and commercial bankers actively structure the terms of proposed issuances of corporate debt to meet the needs of their clients. We also recognize that in doing so, they actively consider their clients' financial, rating agency, accounting, balance sheet, regulatory and other objectives. We see nothing wrong with this, however. Rather, we believe that such structuring directly benefits U.S. corporations and the U.S. economy. In fact, public utilities and other highly regulated industries are among the most frequent issuers of structured debt securities. We see no reason, therefore, why Congress should accept an invitation to disallow interest deductions on these instruments on an ad hoc basis without any coherent legal, economic or policy rationale.

Defer Interest Deductions on Convertible Discount Debt

The President's 1997 budget plan contains a proposal to defer deductions for interest accruing on zero-coupon debt that is convertible into the stock of the issuing corporation until the interest is actually paid. If the holder exchanged the right to receive such accrued but unpaid interest for stock before the instrument matured, the interest deduction would effectively be disallowed altogether.

SIA strongly opposes this provision as lacking a coherent policy rationale. The only possible rationale for the proposed disallowance is that an issuance of convertible discount debt is economically similar to an issuance of equity, and an issuer should therefore not be entitled to deduct interest accruing on discount debt that is ultimately converted into equity. The President has made no proposal, however, to disallow deductions for interest paid on current-pay convertible debt. SIA observes that current-pay convertible debt is far more likely to be converted into equity than is zero-coupon convertible debt. A converting holder of zero-coupon debt must give up the right to receive accrued but unpaid interest; a converting holder of current-pay debt does not give up this right, because the interest has already been received.

This is borne out by the fact that approximately 79% of all current-pay convertible debt instruments are converted into stock prior to maturity, whereas only 30% of all zero-coupon convertible debt instruments are ultimately converted. In other words, it is generally the zero-coupon instruments, not the current-pay instruments, which in fact pay principal at maturity.

Morris Trust Proposal

The President's 1997 budget plan contains a proposal which would effectively impose corporate-level tax on an otherwise tax-free "spinoff" (i.e., distribution to shareholders) of an active business that is planned in contemplation of a merger of the distributing corporation into an acquiring corporation (a so-called "Morris Trust transaction"). Such a spinoff generally occurs because the acquirer is not interested in acquiring the spun-off business, or otherwise does not view itself as in a position to manage the spun-off business in an efficient manner.

SIA strongly opposes this proposal. SIA does not believe the proposal makes sense as a matter of economic policy, legal analysis or technical analysis, and that it stands in the way of transactions serving a bona fide business purpose.

A tax-free spinoff in effect permits deferral, rather than elimination, of corporate-level tax on gain from the appreciation of corporate-level assets. The assets remain in corporate solution for ultimate taxation. In the past, the most important condition which Congress has required for deferring imposition of corporate-level tax on such appreciated assets is that there be a bona-fide business purpose for the spinoff. The business purpose for a spinoff in a Morris Trust transaction--that the acquirer is not willing to own and manage the spun off business--is as compelling and logical a business purpose as taxpayers ever have for wanting to distribute an active business to their shareholders. Indeed, it has in the past been among the business purposes that are most readily accepted by the Internal Revenue Service in issuing spinoff rulings.

There are already many limits on a corporation's ability to effect a tax-free spinoff. These include not only the business purpose requirement discussed above, but also that both the distributing and distributed corporations have been engaged for at least five years in active businesses, and that the spinoff not otherwise constitute a device for the distribution of corporate earnings without imposition of a tax on dividends. In addition, shareholders must have an ongoing continuity of interest in both the distributed corporation and the corporation which acquires the distributing corporation.

The new proposal would require that shareholders actually control the corporation which acquires the distributing corporation, rather than merely retain an ongoing interest in it.

This goes far beyond what is needed to assure continuity of interest in a reorganization. The reorganization and spinoff provisions are designed to permit reorganization of the ownership, management and control of corporate-level businesses so as to create a more productive return for shareholders and the economy at large. We believe the new proposal adds nothing to the already stringent requirements for a tax-free spinoff, and that it unnecessarily impedes the purpose of the spinoff and reorganization provisions.

Short-Against-the-Box Proposal

The President's 1997 budget plan contains a proposal that would treat certain appreciated positions in stock and other financial assets as constructively sold in any case where a taxpayer "substantially eliminates both risk of loss and opportunity for gain for some period".

SIA strongly opposes this provision. As currently drafted, the provision applies not only to transactions which are economically equivalent to sales of appreciated property because they eliminate all of the burdens and benefits of ownership, but also to a broad range of transactions where taxpayers eliminate most, but not all, of the burdens and benefits of ownership. Unless it is substantially revised, the proposal is likely to confuse and chill large, active and beneficial hedging markets merely to eliminate a few highly publicized transactions.

We therefore urge Congress to clarify that constructive sales treatment will not apply merely because a taxpayer enters into hedging transactions--such as swaps, futures, forwards and options--which eliminate most of the economic burdens and benefits of ownership if the taxpayer retains burdens or benefits that prevent the transaction from being the economic equivalent of a sale. For example, Congress should clarify that retention of the benefit of substantial dividends or other income from appreciated property, or retention of the benefit of some amount of appreciation or depreciation of the property (e.g., 5%), will not result in a constructive sale.

We also urge Congress to apply constructive sales treatment only in cases where a taxpayer eliminates all risk of loss and opportunity for gain for a sustained period of time. We believe, for example, that nine months would be a reasonable period of time, since that is the initial term of most options issued on securities exchanges. Elimination of risk of loss and opportunity for gain for but a short period of time does not resemble an outright sale of appreciated property as an economic matter. Rather, it resembles the active and beneficial hedging transactions that are routinely entered into on the nation's securities and commodities exchanges. We observe, in this regard, that if the basis for treating a short-term hedge as a constructive sale is that it is economically equivalent to selling appreciated property and then buying it back, then all appreciated stock should be marked to market, since doing nothing with appreciated stock is also economically equivalent to selling it and then buying it back.

As currently drafted, moreover, the proposal is uncertain and confusing, as to both the mechanics of its application and the consequences of its application. As adequately documented by numerous articles and Bar submissions, the sparse language of this provision raises so many questions that it is impossible to even speculate on how it affects routine business transactions. We respectfully submit that a proposal such as this has simply not been sufficiently thought out to permit Congress to adopt it at this time.

In this regard, if Congress does choose to enact a provision similar to the one proposed by the President, and if Congress grants the Treasury Department authority to treat transactions other than short-against-the-box transactions as resulting in constructive sales, we urge Congress to permit the Treasury Department to apply that authority on a prospective basis only to transactions that are entered into after the date of issuance of detailed and fully considered regulations. In other words, we urge Congress to apply a date-of-enactment effective date to at most certain so-called "short-against-the-box" transactions under which a taxpayer disposes of all of the burdens and benefits of ownership of appreciated stock by borrowing identical stock and selling it short in the marketplace. We note that Congress has taken a similar approach in the past to new rules designed to eliminate abusive straddle transactions and dividend-stripping transactions.

Average Stock Basis Proposal

The President's 1997 budget plan includes a proposal to eliminate the longstanding "identification rule" under which a taxpayer who buys shares of the same stock at different times and later sells less than all of the shares may identify which shares are being sold (usually the shares with the highest basis). Instead, the taxpayer would be treated as having sold shares with an "average basis".

SIA is opposed to this proposal for two reasons. First, we believe it runs directly counter to the broader federal income tax treatment of sales of stock and securities, and therefore leads to anomalous results. If a taxpayer purchases shares of stock A on day one and stock B on day two, the taxpayer is perfectly entitled to choose to sell the shares of stock B, which have a higher basis, rather than the shares of stock A, which have a lower basis. We do not see why the rule should change merely because stock A and stock B are substantially identical. We understand that this proposal may have something to do with the President's concern about short-against-the-box transactions, but the President has already addressed this concern with a more direct proposal.

Second, we believe the provision would, if enacted, lead to greater complexity in the record-keeping and reporting of purchases and sales of stock. Taxpayers (and their agents) would have to maintain and consult with historical records for all of the taxpayer's transactions relating to a given stock each time a taxpayer undertook to sell a few shares. Each sale would change the basis of the remaining shares (presumably under detailed regulations which would explain precisely how the average basis rule works), so that the basis calculations for subsequent sales would depend in part on the mechanics of previous sales. We do not think this approach would be well-suited to routine equity transactions, given their sheer volume and the number of individuals they affect.

Increased Penalties for Failure to File Information Returns

The President's 1997 budget plan includes a proposal to increase penalties for failure to file information returns, including all standard Form 1099s. SIA opposes this provision as unwarranted, in light of the securities industry's generally excellent record for compliance.

The securities industry is proud of the resources and energy which it has devoted to its compliance efforts, and of the cooperative spirit which the industry has demonstrated in joining with the IRS to assure that taxpayer income is fully reported. IRS statistics bear out the fact that compliance levels for securities industry filings are already extremely high. Any failures to file on a timely basis generally owe to the late reporting of year-end information by issuers of securities, or to other unavoidable problems. Under these circumstances, we believe an increase in the penalty for failure to timely file returns would be unfair, and would constitute a failure to recognize and credit the industry's substantial compliance efforts.

Effective Dates

SIA wishes to commend Congressman Archer and Senator Roth for the announcement they made on March 17, 1996 stating, as we understand it, that any of the proposals described above would, if ultimately enacted by Congress, be effective for transactions entered into after the date of appropriate Congressional action. SIA has been troubled by the Administration's recently-developed policy of introducing new proposals for the taxation of financial instruments and transactions effective for transactions entered into after the date of the proposal. SIA has been particularly concerned because the proposals in question have not involved routine or ministerial changes to the taxation of financial transactions, but rather complex and far-reaching changes with many uncertain, and in some cases unintended, consequences.

SIA has a number of objections to the Administration's approach. First, it effectively destroys legitimate business transactions by casting a cloud of uncertainty over their tax treatment before Congress has had a chance to consider the merits of the relevant proposal. Second, it effectively preempts Congress by eliminating transactions which Congress may ultimately approve of. Third, it eliminates the relevant transactions without any hearing as to their merits, or as to the merits or consequences of the relevant proposal. Finally, it eliminates transactions in progress notwithstanding the very substantial costs associated with taking a proposed transaction (over the course of several months) from a mere "mandate" to a mature issuance, complying in a voluntary and cooperative spirit with a maze of regulatory requirements, lining up potential buyers, and forgoing other meaningful and important business alternatives.

SIA understands that the Administration has adopted this policy partly to prevent issuers from "rushing to market" with transactions during the "window period" before Congress enacts a provision which will change their tax consequences. SIA wishes to clarify, however, that most substantial financial issuances and transactions involve a great deal of time, effort and energy. SIA does not believe there would have been any "rush to market" if the President's proposals had been made effective for transactions entered into after the date of enactment. Rather, there would have been "business as usual", and SIA believes that this is what issuers are entitled to unless and until Congress enacts the relevant proposals into law.

JOINT STATEMENT OF:
SECURITIES INDUSTRY ASSOCIATION;
MERRILL LYNCH & CO., INC.;
and
CITICORP

WRITTEN TESTIMONY SUBMITTED TO THE
WAYS AND MEANS COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

REGARDING A PROPOSAL INCLUDED IN PRESIDENT CLINTON'S FISCAL 1997 BUDGET

TO INCREASE PENALTIES FOR FAILURE TO FILE CORRECT INFORMATION RETURNS

MAY 15, 1996

The undersigned companies and associations strongly oppose the Administration's proposal to increase penalties for failing to file correct information returns. The proposal is extremely broad, applying to all types of information returns such as Forms 1099-INT, -DIV, -OID, -B, and -MISC, as well as Form W-2. We believe the proposal is flawed in many respects.

The financial services community devotes an extraordinary amount of resources to complying with current information reporting rules, and information returns play a key role in tax administration. The undersigned companies and trade associations represent a significant portion of the informatoin returns that would be impacted by this proposal. In light of the current reporting burdens imposed on our industry and the benefits derived by the IRS, we believe it is highly inappropriate to raise penalties for inadvertent errors.

Current penalty structure is sufficient

We believe the current penalty structure -- which includes severe sanctions for intentional reporting failures -- gives filers more than enough incentive to comply with information reporting requirements. In general, the current penalty structure is as follows:

- The combined standard penalty for failing to file correct information returns and payee statements is $100 per failure, with a penalty cap of $350,000 per year.

- Significantly higher penalties -- generally 20 percent of the amount required to be reported (for information returns and payee statements) with no penalty caps may be assessed in cases of intentional disregard. It is important to note that the IRS has not hesitated to assess penalties under the intentional disregard provisions.

- Payors also may face liabilities for failure to apply 31 percent backup withholding when, for example, a payee has not provided its taxpayer identification number (TIN).

Furthermore, there is no evidence of a substantial lack of compliance with information reporting requirements. Given the incentives under the current penalty structure, reporting compliance is high and the proposed penalty increase is unnecessary.

<u>Proposal represents significant shift in policy</u>

It seems that any revenue raised by the proposal would result only from higher penalty assessments. None of the added revenue is expected to come from increased compliance with information reporting.

Any reliance on a penalty provision to raise revenue would mark a significant shift in Congress' policy on penalties. A 1989 IRS Task Force on Civil Penalties concluded that penalties "should exist for the purpose of encouraging voluntary compliance ***and not for other purposes, such as the raising of revenue.***"[1] Congress specifically endorsed the IRS Task Force's conclusion in the Omnibus Budget Reconciliation Act of 1989.[2] The Service's Internal Revenue Manual now includes a policy statement reflecting these principles.[3]

There appears to be no justification for Congress to abandon its present policy, which is based on fairness and clear standards. Particularly in light of the high compliance rate for filing information returns, any decision to increase penalties for revenue purposes is completely unjustified.

We also urge you not to rely on the 97-percent substantial compliance "safe harbor" provision of the current proposal as a way of ensuring that the higher penalties apply only to relatively few cases. Although some information reporting rules are straightforward (e.g., interest paid on deposits), the requirements for certain new financial products are often unclear, and there is certainly a risk of inadvertent reporting errors for complex transactions. We also believe there is significant confusion about Form 1099-MISC reporting requirements.[4] Any reporting "errors" resulting from such ambiguities could easily lead to a filer not satisfying the 97 percent safe harbor.

<u>Relief needed for multiple penalty cap problems</u>

If Congress does move forward with the proposal, there is clearly a need to make changes relating to the potential application of multiple penalty caps. Under current law, the $250,000 penalty cap for information returns (section 6721(a)(1)) generally protects the filing community from clearly excessive penalties. Under the proposal, the $250,000 cap would continue to apply, although a filer would reach the penalty cap much faster than under current law. Unfortunately, the effectiveness of the proposed penalty cap is substantially limited for institutions that file information returns under several -- perhaps hundreds -- of different payor names. The problem for these institutions is that the $250,000 cap applies separately to each payor.

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[1] *See* Statement of IRS Commissioner Gibbs before the House Subcommittee on Oversight (February 21, 1989) (p. 5) (emphasis added).

[2] OBRA 1993 Conference Report at 661.

[3] Internal Revenue Manual Policy Statement P-1-18.

[4] For example, major questions regarding the identity of the payor -- obviously a fundamental question for accurate reporting -- exist in multiple party payment situations. *Compare, e.g.*, Rev. Rul. 93-70, 1993-2 C.B. 294 (paying agent required to file Forms 1099-MISC) and Temp. Reg. § 35a.9999-3, Q/A 1 (paying agent not required to file Forms 1099-MISC). A recent court also found the Form 1099-MISC instructions to be "complicated and ambiguous at best." *In re Quality Medical Consultants Inc.*, 76 AFTR 2d ¶ 95-5764.

The most common examples of these problems are described below. In each scenario, the penalty cap is illusory because it applies separately to each legal entity. Assuming Congress abandons its 1989 policy and enacts the current proposal, we recommend how the penalty cap provisions should be applied for each of the situations described below:

1. *Multiple nominees*

   A bank or broker/dealer may use several different nominees (i.e., street names) to hold securities on behalf of its individual customers. Each nominee is treated as a separate payor for information reporting and penalty purposes.

   Recommendation: Nominees used by a bank or broker dealer should not be treated as separate payors for purposes of applying the penalty caps.

2. *Related companies*

   A bank or broker dealer may be comprised of hundreds of affiliated corporations that offer different services and products to customers. Each corporation is treated as a separate payor for information reporting and penalty purposes.

   Recommendation: Different corporations within the same controlled group (as defined under section 267(f)) should be treated as a single payor for purposes of the penalty caps. Alternatively, section 1563(a) could be used as the standard for treating related persons as a single payor.

3. *Mutual funds*

   Each mutual fund within a family of mutual funds is treated as a separate payor for information reporting and penalty purposes.

   Recommendation: Different mutual funds within a single family of funds (i.e., funds with a common investment advisor or principal underwriter) should be treated as a single payor for purposes of applying the penalty cap.

4. *Paying agents*

   A bank may act as a transfer/paying agent for numerous issuers of stocks and bonds. Information returns filed by the bank as agent identify the issuer -- and not the bank -- as the payor. Although the issuer (payor) is technically liable for any penalties, the transfer agent may be required to indemnify the issuer for the penalties.

   Recommendation: A paying agent should be treated as a payor for purposes of applying the penalty cap.

Conclusion

As stated above, the proposal to increase penalties for failing to file correct information returns is unnecessary and is driven solely as a devise to raise revenue through the assessment of higher penalties. The additional revenue will not come from increased compliance as the current penalty structure provides more than enough incentive for filers to comply with information reporting requirements. If it does become necessary to consider this proposal, we would hope that the Committee would make the necessary changes to address the potential application of multiple penalty caps.

This testimony is being submitted by the following trade association and companies:

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May 15, 1996

Mr. Philip D. Mosely
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Mosely:

This letter contains a summary of the position of our client, the Society of Independent Gasoline Marketers of America ("SIGMA"), on the revenue provisions of the President's FY 1997 Budget Proposals. The President's proposals to require that kerosene be taxed at the terminal rack or dyed and to extend the tax to fund the Leaking Underground Storage Tank ("LUST") Trust Fund are of significant interest to SIGMA. SIGMA supports the President's proposal to tax or dye kerosene. SIGMA opposes the extension of the LUST tax, unless the funds are spent to enforce the 1998 tank replacement deadline, reimburse clean up costs, and implement other program improvements as set forth in H.R. 3391, introduced by Rep. Dan Schaefer (R-CO) on May 2, 1996.

SIGMA is a national trade association comprised of approximately 260 chain retailers and independent marketers of motor fuels that market motor fuels in all 50 states and in Puerto Rico. In 1994, SIGMA members sold 30.3 bilion gallons of motor fuels, or about 20 percent of all motor fuels sold in the United States. Of this volume sold, approximately 7.6 billion gallons is diesel fuel. SIGMA members who have replaced their underground tanks have spent approximately $75,000 per outlet to do so, not including remediation costs.

SIGMA supports the President's proposal to tax or dye kerosene at the terminal rack to reduce potential evasion of the tax. Since the enactment of the Omnibus Budget Reconciliation Act of 1993 ("1993 Act"), SIGMA has urged the Internal Revenue Service ("Service") to require that the federal excise tax on diesel fuel be collected on kerosene at the terminal rack or that kerosene be dyed. The 1993 Act requires that any liquid, such as kerosene, that is suitable for use in a diesel powered engine be taxed or dyed upon removal from the terminal rack. The Service has declined to comply with this mandate in the 1993 Act.

The failure to require that kerosene be taxed or dyed provides a significant opportunity for tax evasion. The Service currently requires users of kerosene that blend kerosene with tax-paid fuel below the terminal rack to report such use and remit the tax. Kerosene is frequently blended with diesel fuel for use as a motor fuel in diesel powered trucks, especially during the winter months. Untaxed kerosene that is not dyed can easily be blended without payment of the tax because this type of evasion is not susceptible to enforcement by visual inspection of the fuel, which was the primary purpose of the dyeing requirement for diesel fuel in the 1993 Act.

Any concerns about the use of dyed kerosene by retail consumers in home space heaters can be resolved by permitting retailers of kerosene to obtain refunds of taxes paid on clear kerosene sold for such use. Without such a refund, users of kerosene in home space heaters who have been educated to use only clear fuel, could be faced with the options of using tax-paid fuel and applying for a refund or using dyed fuel. Permitting such a refund would eliminate the need for a consumer to apply for the refund or to use a fuel that he or she has been educated not to use. Such a refund should be paid within 20 days or accrue interest, and should be available only if such kerosene is sold from segregated storage, sold in small quantities, and dispensed through a short hose to prevent diversion of the kerosene to a taxable use.

In addition, marketers who have only one storage tank should be permitted to obtain a refund on tax paid kerosene that is blended with dyed diesel fuel if they can demonstrate that they added dye to the mixture to restore the mixture to the nontaxable fuel dye concentration levels and the fuel was sold for a nontaxable use. Without such a refund, some marketers could be unable to recover taxes paid on clear kerosene mixed with dyed fuel.

SIGMA opposes extension of the LUST tax unless the funds will be truly dedicated to the purposes for which they are collected. SIGMA is concerned that LUST Trust Fund monies will be used to assist owners of underground tanks to avoid the 1998 deadline for replacement of tanks. Such assistance could take the form of direct loans, low interest loans, or loan guaranties for upgrades after the 1998 deadline.

The 1998 deadline should not be extended for anyone. Owners of underground tanks who went to the expense of upgrading their tanks before the deadline should not be forced to compete with tank owners who did not and are then rewarded with an extension and subsidized replacement. The deadline will have been known for 10 years when it is reached. Anyone who is unable to meet the deadline in 10 years should not be permitted to operate.

SIGMA would support the extension of the tax if the funds were actually appropriated to the states to (1) supplement tank assurance funds; (2) enforce existing regulatory requirements; and (3) clean up releases beyond the current statutory period. H.R. 3391 would authorize such uses. LUST Trust Fund appropriations dropped to $45 million in 1996 from $70 million in 1995. With approximately $1 billion in the trust fund, Congress should appropriate these monies for these purposes.

SIGMA appreciates this opportunity to comment to the Committee on Ways and Means. SIGMA looks forward to working with the Committee on these and other tax issues.

Sincerely,

J. Keith Ausbrook

J. KEITH AUSBROOK
Counsel to
Society of Independent Gasoline
Marketers of America

STATEMENT OF TENNECO
ON NEW REVENUE PROVISIONS IN THE PRESIDENT'S FISCAL YEAR 1997 BUDGET

Introduction

Tenneco is pleased to submit this testimony in response to the Committee's request for comments on the new revenue provisions in the Administration's fiscal year 1997 budget. This testimony addresses the Administration's proposal to require gain recognition on certain distributions of controlled corporation stock under section 355 of the Internal Revenue Code. Tenneco opposes the Administration's proposal and supports retaining current law.

Tenneco is a diversified industrial corporation with 1995 sales of $8.9 billion. Tenneco owns and manages businesses in four major sectors: packaging (Tenneco Packaging), automotive parts (Tenneco Automobile) natural gas transmission and marketing (Tenneco Energy), ship design, construction and repair Newport News Shipbuilding)."

The Administration's Proposal

The Clinton Administration, as part of its fiscal 1997 budget plan, has proposed changing the tax treatment of certain corporate restructuring transactions in which a target corporation is acquired by another corporation after the target spins-off an unwanted subsidiary. These so-called Morris Trust transactions, named for the 1966 Fourth Circuit case that permitted this transaction, are treated under current law as tax-free spin-offs and reorganizations. The tax-free treatment of both transactions is rooted in the notion that the shareholders continue to own corporate assets without a change in their tax basis.

The Administration argues that tax-free treatment under Internal Revenue Code Section 355 is not justified in a Morris Trust transaction because the transaction effectively represents a disposition of business assets. The Administration's proposal requires any gain in the controlled corporation be taxed to the distributing corporation even though the distributed assets remain in corporate solution and all other statutory and regulatory requirements are met.

"Spin-Offs" Have Historically Received Tax-Free Treatment

Section 355 of the Internal Revenue Code permits the tax-free separation, including a spin-off, of a group of corporations into two or more corporations. Similar to the treatment of tax-free mergers, the treatment of spin-offs is derived from the notion that the shareholders continue to own corporate assets after the execution of a spin-off, although in a different form. In view of this continuing investment, the tax that would be realized had a sale or disposition occurred is deferred until such time that the assets actually leave corporate solution.

The requirements under Section 355 are designed to prevent taxpayers from using spin-offs for tax-avoidance purposes. These requirements include that (1) the spin-off be supported by a bona fide corporate business purpose, (2) the distributing and controlled corporations each conduct an active five year trade or business, and (3) the transaction not constitute a "device" to distribute earnings and profits.

More than twenty-five years ago, the Fourth Circuit, in *Comm'r v. Mary Archer W. Morris Trust*, 367 F2d 794 (4th Cir. 1966), approved a transaction in which a distributing corporation spun-off an unwanted subsidiary and then, as part of a planned transaction, was acquired in a tax-free merger. Since that case, this transaction, which combines a spin-off under Section 355 and a reorganization under Section 368, has been commonly referred to as a "Morris Trust Transaction."

Example of a Typical Morris Trust Transaction

To illustrate a Morris Trust transaction, assume that a candy business desires to acquire a toy business in a tax free reorganization. The target toy business owns a candy manufacturing company which the acquiring candy business does not wish to acquire because it has no need for the extra manufacturing capacity. In order to accommodate the tax free merger of the toy business into the candy business, the target company spins-off the candy manufacturing company to its shareholders.

Thus, the target toy business shareholders own all of the outstanding stock of two corporations: the toy business and the spun-off candy manufacturing company. The acquiring candy company can now acquire the toy business in a tax free reorganization without also acquiring the unwanted candy manufacturing company. Following the tax free merger of the toy business into the candy business, the former toy business shareholders hold stock in the spun-off candy manufacturing company and the combined candy/toy business. No assets or stock investments have been sold by any shareholders, and the former toy business shareholders have a continuing investment in the toy business through holding the stock of the acquiring candy business stock.

The assets in this transaction never leave corporate solution and no cash is received by either the distributing corporation or any of the shareholders. Therefore, the distributing corporation should not recognize gain and incur a tax liability upon the spin-off of the unwanted subsidiary.

Acquisitive Reorganizations are Tax Free

Under the Internal Revenue Code's reorganization provisions, one corporation is permitted to acquire all (or substantially all) of the assets (or a controlling stock interest) of another corporation on a tax-free basis. This may be accomplished provided that, among other things, the shareholders of the acquired corporation maintain a continuing proprietary interest in the reorganized enterprise. A fundamental assumption underlying these reorganization provisions is that nonrecognition treatment is appropriate where there is a continuity of investment. Shareholders of the acquired corporation must maintain an economic interest in the underlying business through continuing stock ownership.

Importantly, the continuity of proprietary interest test looks to whether the shareholders of the acquired corporation received a sufficient amount of the stock of the acquiring corporation compared to the total value of their interest in the acquired corporation. The shareholders' investment in the acquired corporation is not compared to the total value of the acquiring corporation. After the exchange, the shareholders of the acquired corporation may own a smaller percentage of the acquiring corporation's outstanding shares than they had owned in the acquired corporation. Accordingly, one corporation can acquire another corporation on a tax-free basis by exchanging its stock.

Longstanding Tax Policy Favors the Continuation of Tax Free Treatment of Morris Trust Transactions

The Morris Trust Transaction is entirely consistent with the policies underlying Internal Revenue Code Section 355. In a Morris Trust Transaction, any corporate earnings or built-in gains in the distributing or controlled corporation remain fully within corporate solution and subject to corporate level tax. There is no distribution to shareholders. Accordingly, the Morris Trust Transaction cannot be used by a taxpayer to avoid repeal of the *General Utilities* doctrine. Such corporate earnings or built-in gains will be recognized and taxed at the point a sale or disposition triggers such recognition. The former shareholders of the distributing corporation maintain a continuing interest in the earnings and business of the corporation by virtue of the stock acquired in the reorganization exchange.

The President's proposal, if enacted, would significantly modify the judicially created continuity of shareholder interest test. Without any apparent policy basis, in the case of post spin-off acquisitions, the proposal would overturn the historic ability of a corporation to acquire another corporation on a tax-free basis by exchanging its stock.

The tax-free treatment of the spin-off/merger combination at issue in the *Morris Trust* case was a logical extension of the Federal tax law's treatment of spin-offs and tax free reorganizations. The IRS has accepted and approved the *Morris Trust* decision in a long line of public and private letter rulings issued over the last 25 years. During the Tax Reform Act of 1986, Congress thoroughly reviewed corporate transactions when the *General Utilities* doctrine was repealed. At that time, Congress recognized the sound policy and business necessity of tax-free spin-off/merger transactions and retained them. In addition, although the Treasury Department's final regulations under Internal Revenue Code Section 355 substantially modified several aspects of spin-off treatment, the regulations left the *Morris Trust* result untouched.

Certainty in Business Planning

On March 29, 1996, House Ways and Means Committee Chairman Bill Archer and Senate Finance Committee Chairman Bill Roth announced that the revenue raising provisions included in President Clinton's fiscal 1997 budget, if approved by the Congressional tax-writing committees, would be effective "no earlier than the date of appropriate Congressional action." Tenneco strongly supports the Chairmen's action to ensure that any enacted provisions would not become effective retroactively as proposed by the Administration. This action by the Chairmen ensures that taxpayers can continue to rely on current law in their business planning activities. Thus, business will not "freeze" in anticipation of potential future tax law changes, and can continue day-to-day operations and strategic planning without interruption.